Danger Zone: Acxiom Corp (ACXM)

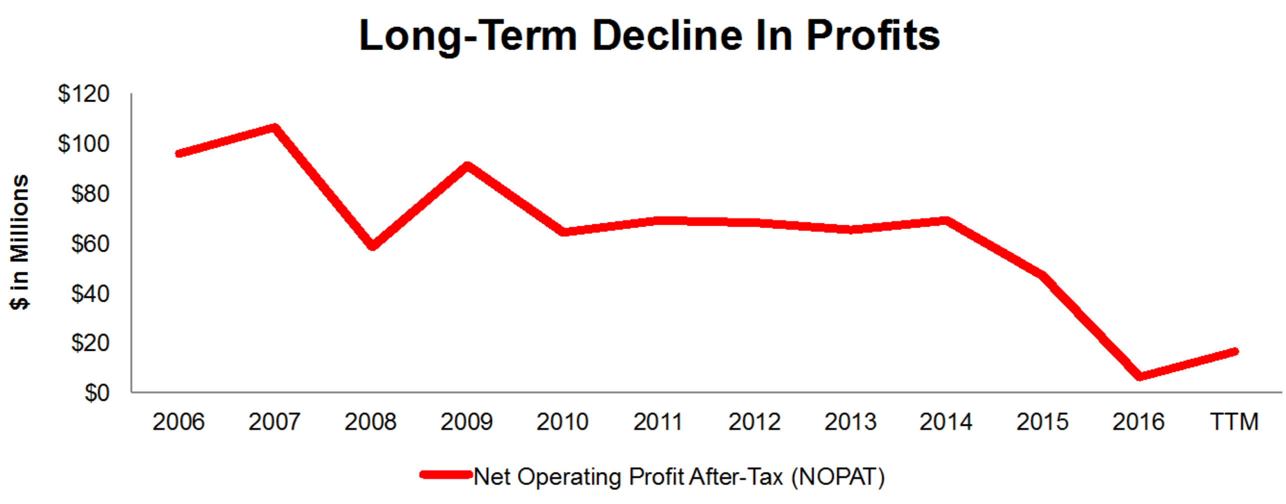
Check out this week's Danger Zone interview with Chuck Jaffe of Money Life and Marketwatch.com

Tracking and making effective use of consumer data can be the difference between a successful marketing campaign and one that falls flat. Aggregating and scaling such data, however, can be costly and time consuming and data providers must differentiate themselves in order to stay relevant. Unfortunately for this firm, profits are falling, competition is rising, and the stock's valuation is priced for perfection. These issues land Acxiom (ACXM: $27/share) on November's Most Dangerous Stocks list and in the Danger Zone this week.

ACXM's Profits Headed In the Wrong Direction

Acxiom's after-tax profit (NOPAT) has declined from $96 million in 2006 to $6 million in 2016, or -24% compounded annually, per Figure 1. The company's NOPAT margin has fallen from 7% in 2006 to 2% TTM.

Figure 1: Acxiom's Shrinking Profits



Sources: New Constructs, LLC and company filings

Profit is not the only fundamental measure in decline either. Acxiom's return on invested capital (ROIC) has fallen from 7% in 2006 to a bottom-quintile 1% TTM. Across many key metrics, Acxiom's business is showing significant signs of weakness.

Compensation Plan Misaligns Executive Interests

Acxiom's executive compensation plan is heavily weighted towards long-term incentive pay (75% for CEO, 58% for other executives), with a smaller focus on annual cash bonuses. However, in each case, the metrics used to award bonuses and incentive pay do not align executive interests with those of shareholders.

Annual cash bonuses are paid out upon the achievement of two metrics, adjusted revenue and adjusted EPS, both non-GAAP metrics. While adjusted revenue removes the impact of acquisitions or divestitures, adjusted EPS removes stock based compensation expense and restructuring and impairment charges, among others.

Long-term incentive pay is awarded through stock options, restricted stock units, and performance stock units. Stock options and RSU's are awarded based on a competitive market analysis while the PSU's are awarded for achieving three year adjusted EPS growth, a non-GAAP metric.

In both forms of compensation, executives are incentivized by non-GAAP metrics that do little to create shareholder value and the adjustments in each allow significant leeway in meeting target goals. We would much rather see executive compensation tied to ROIC, as there is a clear correlation between ROIC and shareholder value. In its current state, ACXM's executive compensation plan has done little to create shareholder value, as its economic earnings, the true cash flows of the business, have declined from -$44 million in 2006 to -$85 million TTM.

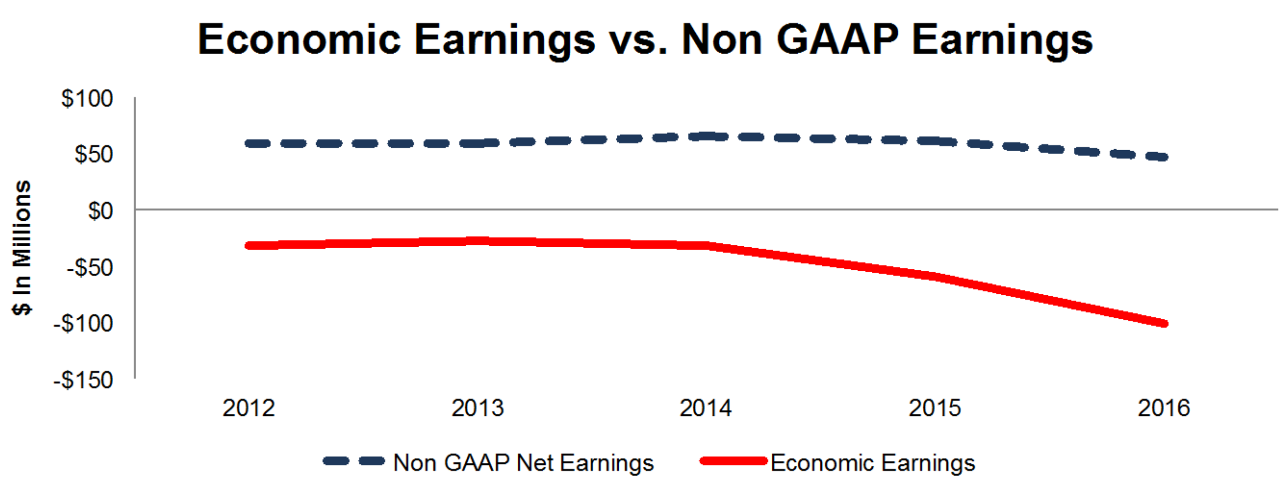
Non-GAAP Metrics Mask Economic Reality

Discretion over the calculation of non-GAAP metrics not only makes them non-comparable across the market, but unreliable measures of the economics of a business. See the dangers of non-GAAP metrics for more details on how companies can abuse non-GAAP. Acxiom's use of non-GAAP EPS, non-GAAP operating income, and adjusted EBITDA distorts the economic reality of the business and gives investors an overly optimistic view of the firm. Below are some of the expenses ACXM removes to calculate its non-GAAP metrics:

1. Restructuring charges
2. Separation and transformation costs
3. Amortization of intangible assets
4. Impairment of goodwill

These adjustments have a significant impact on the disparity between economic earnings and ACXM's non-GAAP metrics. In 2016, ACXM removed over $31 million in stock compensation expense (4% of 2016 revenue). Through the removal of this expense, $12 million in restructuring charges, and other adjustments, Acxiom reported non-GAAP net earnings from continuing operations of $47 million compared to GAAP net earnings from continuing operations of -$9 million and economic earnings of -$101 million. Per Figure 2, since 2012, non-GAAP earnings have fallen from $60 million to $47 million in 2016 while economic earnings have fallen from -$32 million to -$101 million over the same time. While both metrics are in decline, non-GAAP earnings create the illusion of profitability, while the economics of the business only grow more negative.

Figure 2: Discrepancy Between Non-GAAP & Economic Earnings



Sources: New Constructs, LLC and company filings

Diminished Profitability In a Competitive Market

Acxiom's business, combining third party data with customer data and packaging it into useful information, places it in the highly competitive and broad industry of data analytics. Firms across the globe are attempting to find ways to best maximize customer data in order to drive engagement, awareness, and ultimately, profits. Acxiom's goal to aggregate such data, provide infrastructure behind the data, and package it as useful information to clients however has not lead to a winning business strategy. While many of Acxiom's competition is either private, part of a larger firm, or even a partner in some aspects of business, it's clear the company has profitability issues within its industry, per Figure 3.

Firms such as Alliance Data Systems (ADS), which owns Epsilon, Neustar (NSR), CoreLogic (CLGX) and even Oracle (ORCL), which owns Datalogix and BlueKai, earn a higher ROIC and NOPAT margin than Acxiom. With lagging profitability, ACXM's ability to compete on price alone is diminished and in a highly competitive market, pricing power can be key to success. At the same time, with lowered profitability, differentiation can become more difficult as the resources to continually expand the business must instead go towards standard daily operating expenses.

Figure 3: Acxiom's Lagging Profitability

Company	Ticker	Return On Invested Capital (ROIC)	NOPAT Margin
Oracle Corporation	ORCL	24%	28%
Alliance Data Systems	ADS	17%	27%
NeuStar Inc.	NSR	12%	18%
Dun & Bradstreet	DNB	15%	18%
CoreLogic Inc.	CLGX	4%	9%
MDC Partners	MDCA	7%	6%
TeleTech Holdings	TTEC	6%	6%
Acxiom Corp	ACXM	1%	2%

Sources: New Constructs, LLC and company filings

Bull Hopes Ignore Rising Costs In Competitive Landscape

Operating since 1969, scale is not an issue at Acxiom, unlike many other analytics/software/cloud companies that often get lumped together. The company currently serves over 3,000 clients directly and manages data for more than half the Fortune 100. However, despite serving some of the largest and most profitable firms in the United States, ACXM has only seen its profitability collapse, as shown in Figure 1 above. Part of the problem, and a direct contradiction to any bull case, is the spending required to continually grow its customer base, while also maintaining/growing its database and existing services. Over the past three years (2014-2016), Acxiom's operating costs have been growing faster than revenues (3% CAGR), a trend which drives NOPAT margins from 6% to 1%. More details:

- Sales & marketing costs grew 25% compounded annually from 2014-2016.
- General & administrative costs grew 17% compounded annually from 2014-2016.
- Research & development costs grew 9% compounded annually from 2014-2016.

Spending to "grow" the business in this manner is not a recipe for success unless one does not care about profits.

Further weakening profit potential, the consolidation within the data marketing industry has diminished the value of its add-on services. As firms such as Oracle or Alliance Data acquire analytics and marketing platforms, they're able to integrate into their much larger customer relationship management platforms. While these platforms still require data, and may need data from Acxiom, the customer tools and marketing services offered by Acxiom are no longer in demand. The more larger competitors like Oracle build a "one-stop-shop", the weaker is Acxiom's overall value proposition as more potential customers gravitate towards the "one-stop-shop" offerings that tie together more than marketing insights. Ultimately, Acxiom, as a neutral data platform, while valuable, is not worth what its current valuation would imply (more details below).

ACXM Is Priced For Perfection

Despite the clear deterioration in business fundamentals, ACXM is up 42% over the past two years, as investors' appetite for all things cloud/data analytics largely overlooks fundamentals. This significant price increase without a subsequent improvement in the business's cash flow leaves ACXM significantly overvalued.

Specifically, to justify the current price of $27/share, ACXM must immediately achieve 8% pretax margins (average of level over the last five years, compared to 3% TTM) and grow NOPAT by 31% compounded annually for the next 15 years. With the large increase in margins, NOPAT growth significantly outpaces revenue on a compounded annual basis. In this scenario, Acxiom would be generating nearly $7 billion in revenue (15 years from now), which is greater than Alliance Data Systems' fiscal 2015 revenue and equal to the combined revenue of CoreLogic, Dun & Bradstreet, MDC Partners, Neustar, and Teletech from their last fiscal year. In other words, the expectations baked into the stock price imply ACMX taking all market share moving forward.

Even if we assume ACXM can immediately achieve slightly lower 6% pretax margins (average of last three years) and grow NOPAT by 26% compounded annually for the next decade, the stock is only worth $5/share today – an 81% downside. This scenario assumes ACXM can grow revenue by 7% compounded annually (2017 consensus estimate) but with the increase in margins, NOPAT growth significantly outpaces revenue on a compounded annual basis.

Is ACXM Worth Acquiring?

The largest risk to our bear thesis is what we call "stupid money risk", which means an acquirer comes in and pays for ACXM at the current or higher share price despite the stock being significantly overvalued. Accordingly, we only see an acquisition as possible if an acquiring firm is willing to destroy substantial shareholder value.

Below we show just how expensive ACXM remains after assuming an acquirer can gain significant synergies.

To begin, ACXM has liabilities of which investors may not be aware that make it more expensive than the accounting numbers suggest.

1. $69 million in off-balance-sheet operating leases (3% of market cap)
2. $43 million in deferred tax liabilities (2% of market cap)
3. $36 million in outstanding employee stock options (2% of market cap)

After adjusting for these liabilities we can model multiple purchase price scenarios. Even in the most optimistic of scenarios, ACXM remains considerably overvalued.

Figures 4 and 5 show what we think Alliance Data Systems (ADS) should pay for Acxiom to ensure it does not destroy shareholder value. Alliance Data has a history of acquiring marketing data analytics firms such as Epsilon and Conversant, and adding Acxiom could bolster its current offerings. However, there are limits on how much ADS would pay for ACXM to earn a proper return, given the NOPAT of free cash flows being acquired.

Each implied price is based on a 'goal ROIC' assuming different levels of revenue growth. In each scenario, the estimated revenue growth rate in year one and two equals the consensus estimate for 2016 (2%) and 2017 (7%). For the subsequent years, we use 7% in scenario one because it represents a continuation of 2017 expectations. We use 12% in scenario two because it assumes a merger with Alliance Data could create revenue growth through increased sales opportunities across ADS's client base.

We conservatively assume that Alliance Data can grow ACXM's revenue and NOPAT without spending on working capital or fixed assets. We also assume ACXM immediately achieves a 5% NOPAT margin, the average of the past five years. For reference, Acxiom's TTM NOPAT margin is 2%, so this assumption implies immediate improvement and allows the creation of a truly best case scenario.

Figure 4: Implied Acquisition Prices For ADS To Achieve 7% ROIC

To Earn 7% ROIC On Acquisition		
Revenue Growth Scenario	ACXM's Implied Stock Value	% Discount to Current Price
6% CAGR for 5 years	$8	70%
9% CAGR for 5 years	$14	46%

Sources: New Constructs, LLC and company filings.

Figure 4 shows the 'goal ROIC' for ADS as its weighted average cost of capital (WACC) or 7%. Even if Acxiom can grow revenue by 9% compounded annually with a 5% NOPAT margin for the next five years, the firm is not worth more than its current price of $27/share It's worth noting that any deal that only achieves a 7% ROIC would be only value neutral and not accretive, as the return on the deal would equal ADS's WACC.

Figure 5: Implied Acquisition Prices For ADS To Achieve 17% ROIC

To Earn 17% ROIC on Acquisition		
Revenue Growth Scenario	ACXM's Implied Stock Value	% Discount To Current Price
6% CAGR for 5 years	$1.87	93%
9% CAGR for 5 years	$2.49	91%

Sources: New Constructs, LLC and company filings.

Figure 5 shows the next 'goal ROIC' of 17%, which is ADS' current ROIC. Acquisitions completed at these prices would be truly accretive to ADS shareholders. Even in the best-case growth scenario, the most ADS should pay for ACXM is $2.49/share (91% downside). Even assuming this best-case scenario, ADS would destroy just over $2 billion by purchasing ACXM at its current valuation. Any scenario assuming less than 9% CAGR in revenue would result in further capital destruction for ADS.

ACXM Can't Play The Earnings Miss/Beat Game Forever

Acxiom has a history of guiding revenue and earnings expectations at or below the low end of consensus expectations. For fiscal 2015, Acxiom guided revenues and EPS below consensus estimates. In fiscal 2016, it guided below expectations and the pattern has continued into fiscal 2017, when its revenue and earnings estimates failed to surpass consensus. Worse yet, ACXM has further lowered fiscal year guidance when it reported company 2Q17 results.

Why such a concern over continued lowered guidance? Studies have shown that "lowering the bar" is one of the easiest ways for earnings manipulation, which CFOs admit to being prevalent in the market. Through lowered guidance, Acxiom is able to lower the bar and consistently "beat" these lowered expectations. In fact, ACXM has "beat" earnings estimates for 7 consecutive quarters. Earnings beats, whether impressive or simply beating lowered expectations play pivotal roles in moving share price, as many investors focus solely on EPS and technical trading indicators. Such trading strategies could help explain ACXM rising over 140% over the past five years, despite no improvement in fundamentals of the business.

However, ACXM cannot lower the bar forever. Investors will eventually hold management accountable for results. As noted earlier, an immediate improvement in margins and revenue growth above consensus means the days of ACXM lowering the bar have to end for the firm justify the expectations already baked into the stock price. Any future guidance to the downside could sink shares as investors realize the profit growth potential embedded in the stock price is out of reach.

Insider Action and Short Interest Are Low

Over the past 12 months, 478 thousand insider shares have been purchased and 167 thousand have been sold for a net effect of 311 thousand insider shares purchased. These sales represent less than 1% of shares outstanding. Additionally, there are 3.6 million shares sold short, or just under 5% of shares outstanding.

Impact 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 ACXM's 2016 10-K:

Income Statement: we made $61 million of adjustments with a net effect of removing $1 million in non-operating income (<1% of revenue). We removed $31 million related to non-operating income and $30 million related to non-operating expenses. See all the adjustments made to ACXM's income statement here.

Balance Sheet: we made $670 million of adjustments to calculate invested capital with a net increase of $312 million. The most notable adjustment was $233 million (25% of reported net assets) related to asset write-downs. See all adjustments to ACXM's balance sheet here.

Valuation: we made $455 million of adjustments with a net effect of decreasing shareholder value by $192 million. Apart from total debt, which includes $69 million in off-balance-sheet operating leases, the most notable adjustment was $36 million related to outstanding employee stock options. This adjustment represents 2% of ACXM's market cap.

Dangerous Funds That Hold ACXM

The following funds receive our Dangerous-or-worse rating and allocate significantly to Acxiom.

1. Ivy Science & Technology Fund (WSTBX) – 3.1% allocation and Dangerous rating.
2. Baron Opportunity Fund (BIOIX) – 2.9% allocation and Dangerous rating.
3. Chartwell Small Cap Value Fund (CWSIX) – 2.1% allocation and Dangerous rating.
4. Neuberger Berman Intrinsic Value Fund (NINAX) – 2.1% allocation and Very Dangerous rating.

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

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2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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