# Danger Zone Highlights & Lowlights From 2016

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

Our Danger Zone reports aim to identify those firms that, when looking below the surface, have struggling businesses and highly overvalued stock prices. By identifying alarming non-GAAP trends, unsustainable costs, and questionable acquisitions, we are able to alert readers to potential ticking time bombs. We consider these Danger Zone highlights.

However, the thesis does not always play out as we expect and, at times, the stock continues garnering investor interest and only grows more overvalued. We consider these Danger Zone lowlights. Below presents the Danger Zone highlights of 2016, followed by the lowlights.

**Danger Zone Highlights**

It pays to read our Danger Zone reports. In 2016, 15 out of our 33 Danger Zone stock and mutual fund picks saw negative returns and 20 stocks underperformed the market (S&P 500). As 2016 is now in the rear view, we'd like to highlight a few of the many examples where our Danger Zone reports could have saved investors from serious portfolio damage. All told, the Danger Zone stocks averaged a 5% return in 2016, which was below the S&P 500's return of nearly 10%, thereby outperforming as a short portfolio.

1. **Highlight 1: Valeant Pharmaceuticals (VRX) – published February 29: Down 78% vs. S&P up 16%**

We first highlighted Valeant's corporate governance issues in June 2014, during its hostile takeover attempt of Allergan. Many of the issues Allergan pointed to when fending off the takeover remained in place when we put VRX in the Danger Zone in February 2016. In this report, we specifically pointed out that Valeant's history of acquisitions had clearly destroyed value, and it was using non-GAAP metrics to mask free cash flow losses.

When analyzing the non-GAAP metrics, we found that, since 2010, Valeant's "cash earnings" had grown from $421 million to $3.6 billion, all while the firm burned through $38 billion in free cash flow. Compounding the cash burn, Valeant's executive compensation prioritized revenue growth and "cash EPS," which conveniently removed acquisition related costs. Ultimately, executive interests were not aligned with those of shareholders and the effects were damaging to many shareholders.

The big decline for VRX began early in 2016 when questions arose regarding Valeant's relationship with Philidor and its subsequent accounting practices. Next, Valeant delayed reporting quarterly results, which, eventually, came in well below expectations. It provided guidance that failed to meet consensus expectations and revealed VRX faced default risk were it not to file its 10-K with the SEC by an already extended deadline. Essentially, the house of cards was imploding. Valeant could no longer hide losses with non-GAAP metrics and, ultimately these non-GAAP numbers could not pay the real bills.

All told, Valeant fell 78% since our Danger Zone report was published and was down 87% in 2016. VRX still faces numerous issues, such as a heavy debt load and potential asset sales which could weaken future earnings potential. VRX still earns our Dangerous rating and despite the large decline, 2017 could prove another troublesome year.

2. **Highlight 2: Acadia Healthcare (ACHC) – published July 19: down 38% vs. S&P up 3%**

Acadia Healthcare had all the makings of a Wall Street roll-up scheme, where continual acquisitions boost accounting earnings, make investment banks and executives richer, and, ultimately, destroy shareholder value. Since 2011, Acadia did over 25 acquisitions, which cost upwards of $5.3 billion. While these acquisitions helped grow revenue, the firm's economic earnings declined from -$13 million in 2011 to -$153 million in 2015.

Unfortunately for investors, ACHC was masking these losses with non-GAAP metrics that removed stock-based compensation expense and transaction costs related to acquisitions. At the same time, executives were incentivized with adjusted EBITDA and adjusted EPS goals, which meant shareholder value creation was not a priority.

In the end, Acadia's acquisitions have proven to be as troublesome as we believed. A roll-up scheme can only last as long as a firm can continue to find acquisitions to boost the top line, and Acadia's acquisition of Priory



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essentially threw a wrench in the "roll-up gears." This acquisition was meant to expand ACHC's business in the United Kingdom, but since then, citizens voted to leave the European Union, diminishing future growth prospects, and the UK's Competition and Markets Authority raised concerns that it could lower competition in the market.

These concerns took a toll on the stock, as investors were forced to analyze the fundamentals of the business now that the acquisitions weren't around to boost poor results. The result? The stock fell throughout the year, and ended 2016 down 38% since our Danger Zone report was published and down 47% for the entire year. ACHC still earns our Dangerous rating and more downside could be ahead.

3. **Highlight 3: FireEye Inc. (FEYE) – published June 27: down 19% vs. S&P up 12%**

FireEye fit the mold of many new technology stocks, namely high revenue growth in an industry ripe for innovation. After falling 50% over the past two years, many believed the stock was undervalued and FEYE was up 30% from May through June 2016. However, the fundamentals of the business, which had been poor, did not warrant such an increase in valuation and FEYE was even more overvalued after this price increase.

The biggest concern with FireEye was its rapidly growing costs. From 2012-2015, FireEye's research & development costs, sales & marketing costs, and general and administrative costs grew 157%, 92%, and 110% compounded annually respectively. At the same time, cost of revenues grew by 136% compounded annually while revenue grew 96% compounded annually over the same time. Essentially the company was spending an unsustainable amount of money to grow revenue at levels that would meet the lofty expectations embedded in the stock's valuation.

Cost issues aside, we also noted in our report that FEYE's best chance at being bought out may have passed. In June, Bloomberg reported the firm turned down multiple takeover offers because they believed the purchase offers did not properly value the firm. Unfortunately for investors, FEYE may have been better off accepting a buyout, as the stock was trading at $16/share at the time, and is now much lower, at $12/share.

The cost problems noted above didn't take long to rise to the forefront, as FEYE reported revenue below expectations and a restructuring of the firm's workforce in its Q2 earnings. This earnings miss provided the catalyst that would sink shares, and FEYE ended 2016 down 19% from the time our Danger Zone report was published, and down 43% for the entire year. FEYE still earns our Dangerous rating and its valuation still implies significant future profit growth. Investors believing now may be the time to buy should look at recent history before doing so.

**Danger Zone Lowlights**

While reviewing some of the most successful calls is important, it is of equal importance to analyze Danger Zone picks that went the opposite way we expected. While we may have been wrong in 2016, the underlying issues that led these companies to be placed in the Danger Zone in the first place made them rather risky investments.

1. **Lowlight 1: Mattress Firm (MFRM) – published July 25: Up 111% vs. S&P up 3%**

Mattress Firm presented another situation where a roll-up scheme could potentially unravel and leave investors with significant losses. MFRM had acquired 15 companies since 2013 to grow revenue and market share, all while economic earnings had declined from -$14 million in 2012 to -$111 million over the last twelve months (TTM). These acquisitions were also a huge strain on MFRM's balance sheet, as debt grew 42% compounded annually from 2013-16. The debt grew to more than double the firm's market cap when we published our report.

Similar to Valeant, Mattress Firm executives were also incentivized by non-GAAP metrics, which removed stock-based compensation, and acquisition related costs. These adjustments meant executives got paid regardless of how much value each acquisition actually ended up destroying. Further compounding the issues, Mattress Firm's profitability fell below common retailers with razor thin profit margins. Without a significant change in business model, Mattress Firm's roll-up scheme would be revealed, as its ability to mask losses ran out.

Unlike Valeant though, Mattress Firm received a buyout offer before the issues could be revealed, and wisely agreed to the purchase price of $2.4 billion, or $64/share. This purchase price represented a 115% premium to the prior day's trading price. Effective September 2016, Mattress Firm was acquired by Steinhoff International, and was up 111% since we published our Danger Zone report.

2. **Lowlight 2: WhiteWave Foods (WWAV) – published February 1: Up 48% vs. S&P up 15%**

In our report on WhiteWave, we noted, "2016 could be the year of the ill-advised acquisition." Little did we know that not only would this statement turn out to be true, but it would greatly impact multiple Danger Zone picks, including WhiteWave.

We placed WhiteWave in the Danger Zone largely due to its misleading earnings, caused by GAAP net income growing at 11% compounded annually since 2012 while economic earnings declined from -$5 million to -$43 million TTM. This large discrepancy was in part due to WhiteWave's acquisitional growth strategy, which as we have pointed out before, due to the high-low fallacy, can artificially manufacture EPS growth while destroying shareholder value. While WWAV's acquisitions were "accretive" to EPS, its debt grew 39% compounded annually from 2012-2014 and its free cash flow in 2015 was -$641 million.

Compounding the firm's negative profitability, the bull case rested on WhiteWave continuing to grow its top and bottom line, presumably through acquisitions. However, pursuing more acquisitions would only exacerbate the cash flow issues and would've required significant additional capital down the road. The stage was set for WWAV's acquisitions to expose the poor business fundamentals and, in turn, the valuation would adjust to a more rational level. As it was, the valuation implied that not only would WWAV be highly profitable, but also that it would grow profits by 20% compounded annually for 14 years, a feat that would be difficult to achieve when burning cash through costly acquisitions.

However, as with Mattress Firm, WWAV found a suitor willing to acquire its business at a value well above the current share price. In early July, WWAV announced it had agreed to a merger agreement with Danone, which valued WWAV at $12.5 billion, of $56/share. WWAV was trading around $47/share prior to the announcement so this purchase price represented a premium ~20%. The merger remains on track to close in early 2017, and WWAV ended 2016 up 48% since we published our Danger Zone report.

3. **Lowlight 3: Interactive Intelligence (ININ) – published June 13: Up 34% vs. S&P up 8%**

Interactive Intelligence presented a unique wrinkle to the traditional "tech company." Rather than a new start-up burning through cash, ININ was profitable from 2000-2010. In 2010, the company began transitioning to cloud based products, and its profitability disappeared during the transition. In fact, ININ's economic earnings declined from $12 million in 2010 to -$26 million in 2015.

Masking these losses were non-GAAP metrics, including non-GAAP operating income, adjusted EBITDA, and non-GAAP net income. Items removed from these metrics included stock-based compensation expense and acquisition related expenses, which allowed ININ to report a non-GAAP net income of $1 million in 2015, compared to GAAP net income of -$22 million and economic earnings of -$26 million.

When looking for a way out of the profit tailspin from 2010-2015, the future didn't look too promising. While ININ operated in the cloud based services industry, its profitability fell below many competitors, and worst of all, its costs were growing significantly faster than revenues. Research & development costs, sales & marketing costs, and general & administrative costs grew by 23%, 21%, and 24% compounded annually from 2010-2015 – all of which were higher than Interactive Intelligence's 19% overall revenue CAGR over this same time.

Putting the nail in the coffin so to speak, even when creating a best case scenario, we calculated the most an acquirer, such as Cisco Systems (CSCO), should pay for ININ while still earning a quality ROIC was $49/share. At the time, ININ was trading at $46/share so even this valuation presented little upside.

Unfortunately we underestimated the willingness of an outside firm to overpay, and in late August, Interactive Intelligence agreed to a merger agreement with Genesys, which valued ININ at $1.4 billion, or $61/share. This acquisition was completed in early December and ININ ended up 34% since we published our Danger Zone report.

**Lesson learned:** Despite the numerous issues noted above, including profitability, competition, and misleading metrics, never underestimate the "stupid money risk" in the market. The risk that an acquirer will pay well above the current share price despite the stock being significantly overvalued can quickly erase any thesis as to why a firm is overvalued.

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

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