New Stocks on Most Attractive/Most Dangerous: January 2017

Recap from December Picks

Our Most Attractive Stocks (+5.5%) outperformed the S&P 500 (+2.2%) last month. Most Attractive Large Cap stock InterDigital (IDCC: $91/share) gained 18%. Most Attractive Small Cap stock Francesca's Holdings (FRAN: $19/share) was up 19%. Overall, 27 out of the 40 Most Attractive stocks outperformed the S&P 500 in December.

Most Dangerous Large Cap stock Dollar Tree (DLTR: $78/share) fell by 11% and Most Dangerous Small Cap Stock VOXX International (VOXX: $5/share) fell by 5%. Overall, 13 out of the 40 Most Dangerous stocks outperformed the S&P 500 in December.

The successes of the Most Attractive and Most Dangerous stocks highlight the value of our forensic accounting as featured in Barron's. Our research helps clients fulfill fiduciary duties when making investment recommendations.

14 new stocks make our Most Attractive list this month and 10 new stocks fall onto the Most Dangerous list this month. January's Most Attractive and Most Dangerous stocks were made available to members on 1/4/17.

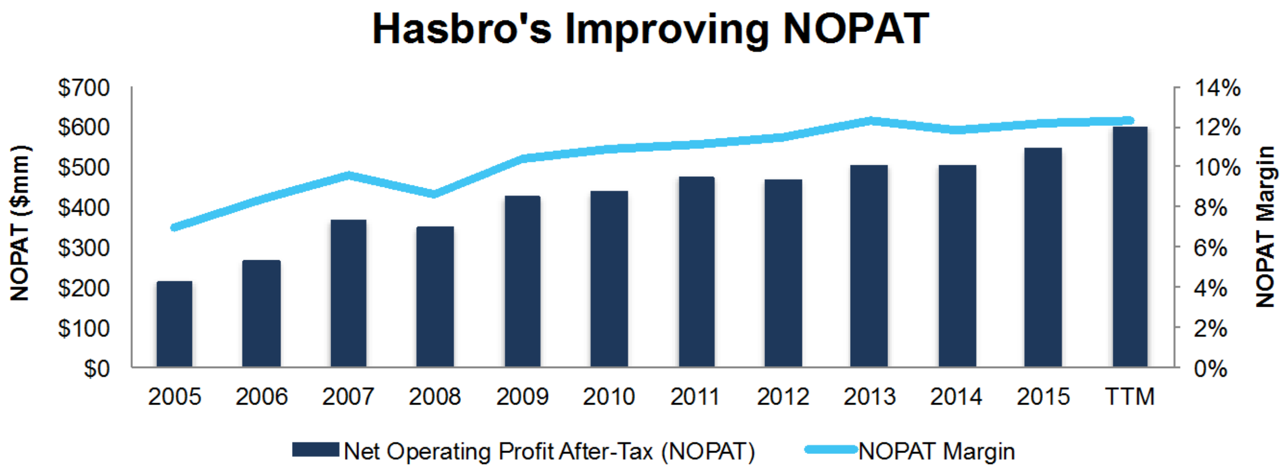
Our Most Attractive stocks have high and rising returns on invested capital (ROIC) and low price to economic book value ratios. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

Most Attractive Stocks Feature for January: Hasbro Inc. (HAS: $83/share)

Hasbro Inc. (HAS), global toy and game manufacturer, is one of the additions to our Most Attractive stocks for January. We recently featured Hasbro in September 2016 when it was added to our Exec Comp Aligned With ROIC Model Portfolio. Despite the stock rising 6% since the publish date (S&P 500 +4%), HAS remains undervalued.

Over the past decade, Hasbro has grown after-tax profit (NOPAT) by 10% compounded annually to $542 million in 2015 and $599 million over the last twelve months (TTM). Per Figure 1, Hasbro has also improved its NOPAT margin from 7% in 2005 to 12% TTM.

Figure 1: Hasbro's History of Profit Growth



Sources: New Constructs, LLC and company filings

Hasbro currently earns a return on invested capital (ROIC) of 14% and has generated a cumulative $2.1 billion in free cash flow over the past five years.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

Impacts of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to Hasbro's 2015 10-K:

Income Statement: we made $204 million of adjustments, with a net effect of removing $91 million in non-operating expense (2% of revenue). We removed $57 million in non-operating income and $147 million in non-operating expenses. You can see all the adjustments made to HAS's income statement here.

Balance Sheet: we made $2.3 billion of adjustments to calculate invested capital with a net increase of $131 million. The largest adjustment was $432 million due to asset write-downs. This adjustment represented 12% of reported net assets. You can see all the adjustments made to HAS's balance sheet here.

Valuation: we made $2.7 billion of adjustments with a net effect of decreasing shareholder value by $1.5 billion. Apart from total debt, which includes off-balance sheet debt, one of the most notable adjustments was the removal of $155 million due to underfunded pensions. This adjustment represents 2% of Hasbro's market cap. Despite the decrease in shareholder value, HAS remains undervalued.

Hasbro Shares Remain Undervalued

The market has rewarded Hasbro for its consistent profit growth and the stock is up 150% over the past five years. In spite of this price increase, shares remain undervalued. At its current rice of $83/share, Hasbro has a price to economic book value (PEBV) ratio of 1.0. This ratio means the market expects Hasbro to never grow profits for the remainder of its corporate life. This expectation seems rather pessimistic for a company that has grown NOPAT by 10% a year for the past decade.

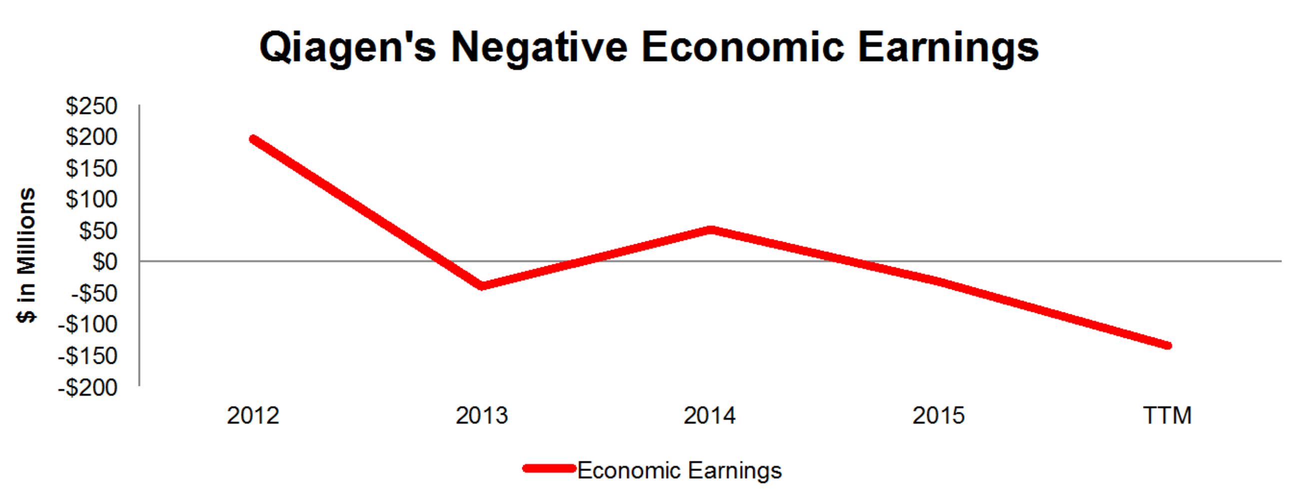
If Hasbro can maintain TTM NOPAT margins (12%) and grow NOPAT by just 6% compounded annually for the next decade, the stock is worth $113/share today – a 36% upside. Add in Hasbro's 2.5% dividend yield and it's clear why HAS was added to this month's Most Attractive Stocks Model Portfolio.

Most Dangerous Stocks Feature: Qiagen N.V. (QGEN: $29/share)

Qiagen N.V. (QGEN), medical research service provider, is one of the additions to our Most Dangerous stocks for January. We first featured Qiagen N.V. in April 2016 when it first made our Most Dangerous stocks list. Since then, the stock is up over 20% (S&P 500 +9%) despite the fact that the fundamentals of the business have only worsened.

Qiagen's economic earnings, the true cash flows of the business, have declined from $196 million in 2012 to -$135 million TTM, per Figure 2.

Figure 2: Qiagen's True Profits Remain Negative



Sources: New Constructs, LLC and company filings

In addition to declining economic earnings, QGEN's ROIC has fallen from a once impressive 13% in 2006 to a bottom-quintile 4% TTM. The firm has burned through $415 million in free cash flow over the past five years.

Impacts of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to Qiagen's 2015 10-K:

Income Statement: we made $67 million of adjustments, with a net effect of removing $47 million in non-operating expense (4% of revenue). We removed $10 million in non-operating income and $57 million in non-operating expenses. You can see all the adjustments made to QGEN's income statement here.

Balance Sheet: we made $982 million of adjustments to calculate invested capital with a net increase of $94 million. One of the largest adjustments was $262 million due to other comprehensive income. This adjustment represented 7% of reported net assets. You can see all the adjustments made to QGEN's balance sheet here.

Valuation: we made $1.5 billion of adjustments with a net effect of decreasing shareholder value by $801 million. The largest adjustment to shareholder value was $1.1 billion in total debt, which includes $48 million in off-balance sheet operating leases. This lease adjustment represents 1% of Qiagen's market cap.

Fundamental Declines Leave QGEN Overvalued

Despite the deterioration in the fundamentals of the business, QGEN is up 25% over the past two years, which makes shares greatly overvalued. In order to justify its current price of $29/ share, QGEN must grow NOPAT by 12% compounded annually for the next decade. This expectation seems overly optimistic given that QGEN's NOPAT has grown by less than 1% compounded annually over the past five years.

Even if QGEN can grow NOPAT at a more reasonable, yet still optimistic, 6% compounded annually for the next decade, the stock is worth $17/share today – a 26% downside. Each of these scenarios assumes Qiagen is able to grow NOPAT/free cash flow without spending on working capital or fixed assets. This assumption is unlikely but allows us to create very optimistic scenarios that demonstrate how high expectations in the current valuation are. For reference, QGEN's invested capital has grown on average $257 million (20% of 2015 revenue) per year over the past five years.

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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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We find it. You benefit. Cutting-edge technology enables us to scale our forensic 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.

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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.

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