New Constructs®
Diligence | Independence | Performance

**DILIGENCE PAYS** 3/20/17

# Filing Season Finds: Week Of March 13-17

Our latest featured stock is a small cap investment company with some significant hidden expenses.

Last week, our analysts parsed 350 filings and collected 43,532 data points. In total, they made 7,185 adjustments with a dollar value of $460 billion. That breaks down into:

- 2,917 income statement adjustments with a total value of $35 billion
- 3,043 balance sheet adjustments with a total value of $210 billion
- 1,225 valuation adjustments with a total value of $214 billion

**Figure 1: Filing Season Diligence**

| | Filings Parsed | Data Points Collected | # of Adjustments | Total Value of Adjustments ($Billions) |
|---|---|---|---|---|
| Last Week | 350 | 43,532 | 7,185 | $460 |
| Filing Season Total | 1,880 | 261,099 | 44,263 | $13,377 |

Sources: New Constructs, LLC and company filings.

During the past week of filing season, we found a change in accounting policies from Manitowoc (MTW), a misleading ROIC calculation from Lincoln Electric (LECO), and an unusual tax benefit from Pzena Investment Management (PZN). Follow us on Twitter and check out the hashtag #filingseasonfinds for regular updates on our research.

Every year in this six-week stretch from mid-February through the end of March we parse and analyze roughly 2,000 10-Ks to update our models for companies with a 12/31 fiscal year end. This effort is made possible by the combination of expertly trained human analysts with what we call the "Robo-Analyst." The Robo-Analyst uses machine learning and natural language processing to automate much of the parsing process.

### A Fiduciary Level of Diligence

Our technology enables us to deliver fundamental diligence at a previously impossible scale. We believe that in time investors will come to demand this level of diligence when it comes to their investment advice.

Only by reading through the footnotes and making adjustments to reverse accounting distortions can advisors go beyond the suitability standard and provide a fiduciary level of diligence to their clients.

### One Company To Watch In 2017

Based on our analysis of Compass Diversified Holdings' (COTI) 10-K, we have upgraded the stock from Dangerous to Neutral.

Senior Analyst Lindsay Bohannon identified two significant hidden items that artificially depressed COTI's reported GAAP net income in 2016.

First, COTI reported a non-recurring, non-cash charge of $17.4 million due to the amortization of the step-up in inventory basis from its acquisition of tactical clothing brand 5.11. This charge was found on page 28 of the footnotes, page 157 overall.

Second, COTI increased its inventory reserve by $4.2 million. This change was found on page 31 of the footnotes, page 160 overall.

In addition to these hidden items, we made several adjustments for items found directly in the financial statements, including:

- Adding back $25 million in write-downs to both NOPAT and invested capital
- Adding back $25 million in interest expense to NOPAT

- Subtracting $660 million in long-term debt and deferred tax liabilities from our calculation of economic book value

After making these adjustments, we found that COTI's NOPAT in 2016 was $107 million compared to GAAP net income of just $25 million. COTI was significantly more profitable than its income statement would suggest.

We still have concerns about COTI, including its negative free cash flow and its relatively modest return on invested capital (ROIC) of 7%. Still, the improvements in 2016 were enough to push the stock out of Dangerous territory.

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*Disclosure: David Trainer, Lindsay Bohannon, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.*

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## New Constructs® – Profile

### How New Constructs Creates Value for Clients

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.

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

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.

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