



New Stocks on Exec Comp Aligned With ROIC Model Portfolio: March 2017

Six new stocks make our [Exec Comp Aligned With ROIC](#) Model Portfolio this month. [March's Exec Comp Aligned With ROIC Model Portfolio](#) was made available to members on 3/15/17.

Recap from February's Picks

Our Exec Comp Aligned With ROIC Model Portfolio (-1.5%) underperformed the S&P 500 (+1.0%) last month. The best performing stock in the portfolio was Children's Place (PLCE), which was up 13%. Overall, five out of the 15 Exec Comp Aligned With ROIC Stocks outperformed the S&P in February.

Since inception, this model portfolio is up 24% while the S&P 500 is up 12%.

The success of the Exec Comp Aligned With ROIC Model Portfolio highlights the value of our forensic accounting ([featured in Barron's](#)). Return on invested capital ([ROIC](#)) is the [primary driver of shareholder value creation](#). By analyzing [footnotes](#) in SEC filings, we are able to calculate an accurate and comparable ROIC for 3000+ companies under coverage.

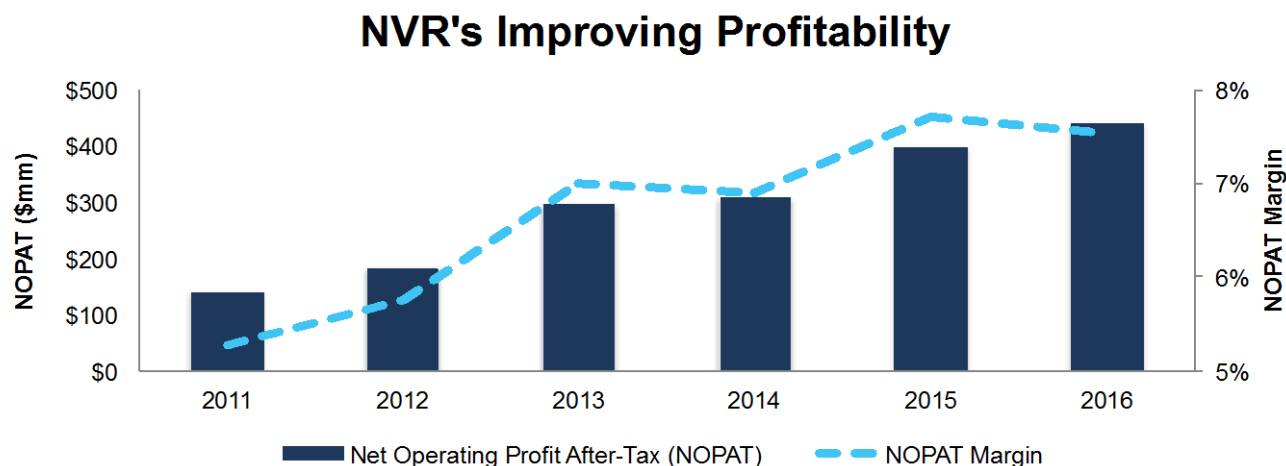
This Model Portfolio only includes stocks that earn an [Attractive or Very Attractive](#) rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas.

New Stock Feature for March: NVR Inc. (NVR: \$2,016/share)

NVR Inc. is one of the additions to our Exec Comp Aligned With ROIC Model Portfolio in March.

Since 2011, NVR has grown after-tax profits ([NOPAT](#)) by 26% compounded annually. Per Figure 1, NVR's NOPAT margin is currently just under 8%, which is up from 5% in 2011.

Figure 1: Growing Profits & Margins



Sources: New Constructs, LLC and company filings

NVR currently earns a top-quintile 21% return on invested capital ([ROIC](#)) and has generated a cumulative \$821 million (11% of market cap) in [free cash flow](#) over the past five years.

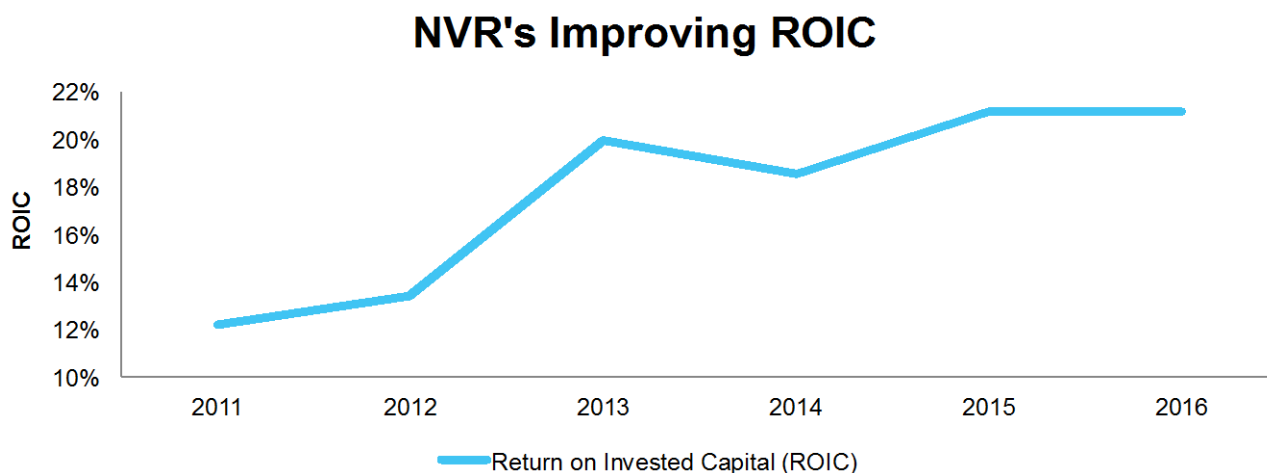
Executive Compensation Aligned With ROIC Creates Shareholder Value

Return on capital has been part of NVR's executive compensation plan since 2014. In 2016, half of NVR's equity grants were tied to the firm's return on capital performance. For performance-based options, vesting is subject to NVR's return on capital relative to its peer group.



The focus on return on capital helps ensure executives are good stewards of capital. Despite only adding return on capital to its compensation plan in 2014, NVR has a history of improving its ROIC. Per Figure 2, NVR's ROIC has improved from 12% in 2011 to its current 21%. Longer-term, NVR has earned a double digit ROIC in every year of our model, which dates back to 1998.

Figure 2: Improving ROIC Improves Shareholder Value



Sources: New Constructs, LLC and company filings

We've detailed ways in which ROIC is directly correlated to changes in shareholder value [here](#). NVR's use of return on capital to measure performance ensures executives' interests are aligned with shareholders' interests.

NVR Remains Undervalued Despite Strong Fundamentals

Investors have clearly rewarded NVR for its improving fundamentals and the stock is up 176% over the past five years, while the S&P 500 is up 69%. Despite this increase in stock price, NVR remains undervalued.

At its current price of \$2,016/share, NVR has a price to economic book value ([PEBV](#)) ratio of 0.8. This ratio means the market expects NVR's NOPAT to permanently decline by 20%. This expectation seems overly pessimistic for a firm that has grown NOPAT by 26% compounded annually since 2011.

If NVR can maintain current NOPAT margins (7.5%) and [grow NOPAT by just 8% compounded annually over the next five years](#), the stock is worth \$3,594/share today – a 78% upside.

Impacts of Footnotes Adjustments and Forensic Accounting

Our [robo-analyst technology](#) enables us to perform forensic accounting with scale and provide the [research needed](#) to fulfill fiduciary duties.

In order to derive the [true recurring cash flows](#), an accurate [invested capital](#), and an accurate shareholder value, we made the following adjustments to NVR's 2016 10-K:

Income Statement: we made \$44 million of adjustments, with a net effect of removing \$14 million in non-operating expense (<1% of revenue). We removed \$15 million in [non-operating income](#) and \$29 million in [non-operating expenses](#). You can see all the adjustments made to NVR's income statement [here](#).

Balance Sheet: we made \$1.4 billion of adjustments to calculate invested capital with a net increase of \$770 million. One of the largest adjustments was \$390 million due to [asset write-downs](#). This adjustment represented 30% of reported net assets. You can see all the adjustments made to NVR's balance sheet [here](#).

Valuation: we made \$1.4 billion of adjustments with a net effect of decreasing shareholder value by \$1.3 billion. One of the most notable adjustments to shareholder value was the removal of \$583 million in [outstanding employee stock options](#). This adjustment represents 8% of NVR's market cap. Despite the decrease in shareholder value, NVR remains undervalued.

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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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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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