



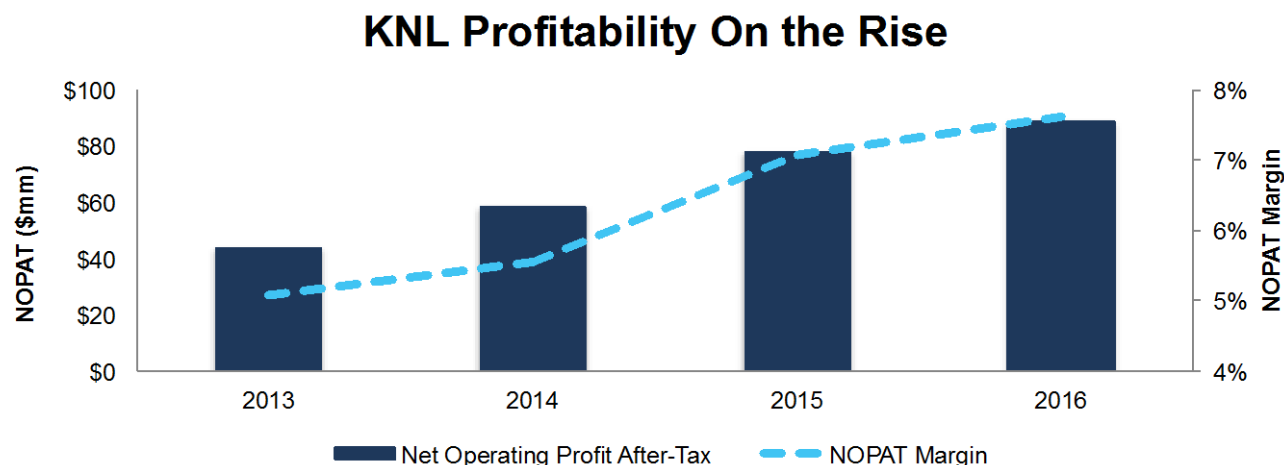
Long Idea: Knoll Inc. (KNL)

Market overreactions create buying opportunities. Despite improving profits, margins, and ROIC, the market recently punished this stock for “missing expectations.” Add in improving market conditions and prudent cost management to this backdrop of lowered expectations, and we believe the stock is positioned to outperform moving forward. Knoll Inc. (KNL: \$24/share) is this week’s [Long Idea](#) and on [April’s Most Attractive Stocks](#) list.

KNL’s Impressive Profit Growth

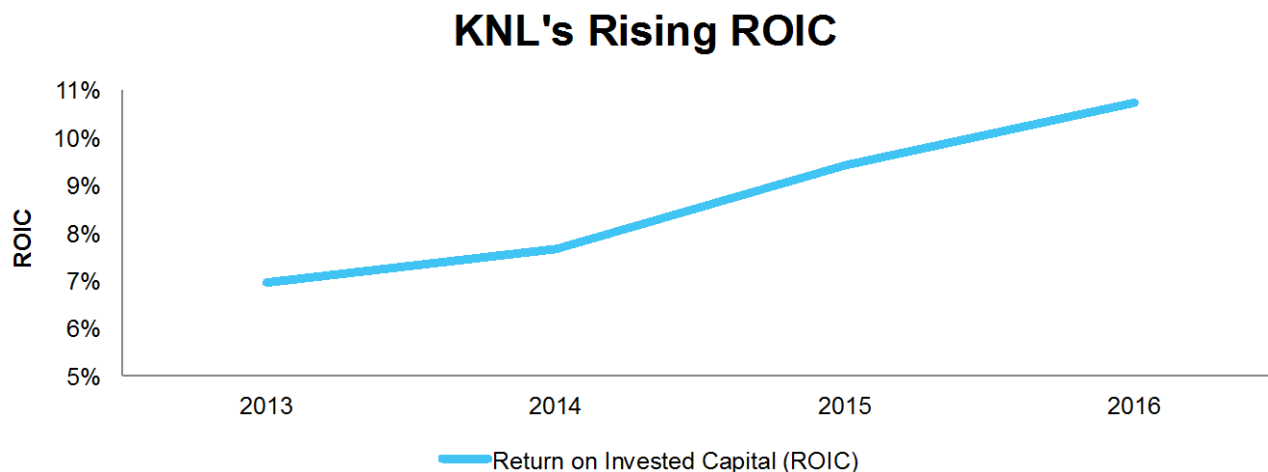
Since 2013, Knoll has grown ([NOPAT](#)) by 27% compounded annually to \$89 million in 2016. The company has grown revenue by 11% compounded annually over the same time. Per Figure 1, the company’s NOPAT margin has improved from 5% in 2013 to nearly 8% in 2016. Longer-term, Knoll has grown NOPAT by 7% compounded annually since 2004.

Figure 1: KNL Profit Growth Since 2013



Sources: New Constructs, LLC and company filings

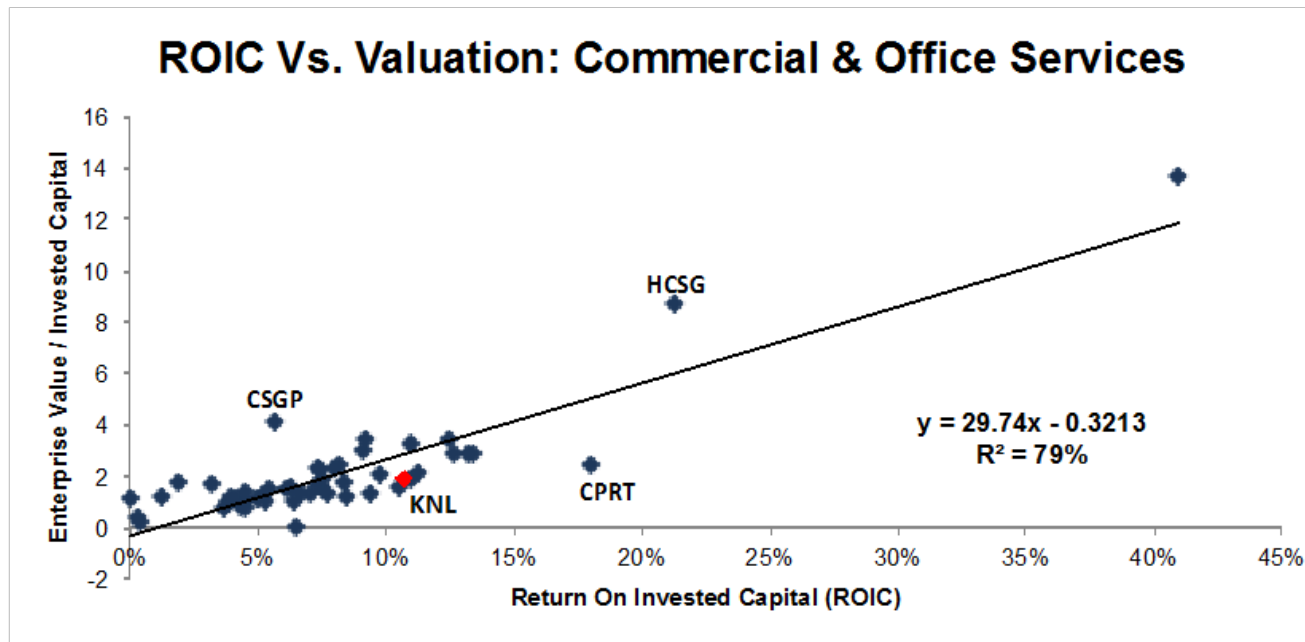
In addition to NOPAT growth, Knoll has generated a cumulative \$85 million (6% of market cap) in free cash flow ([FCF](#)) over the past five years. Knoll has also exhibited good stewardship of capital amidst multiple acquisitions aimed at diversifying the business. Since 2013, Knoll has improved its return on invested capital ([ROIC](#)) from 7% to 11%, per Figure 2.

**Figure 2: Knoll's Good Stewardship of Capital**

Sources: New Constructs, LLC and company filings

Improving ROIC Correlated With Creating Shareholder Value

Per Figure 3, ROIC explains 79% of the changes in valuation for the 52 Commercial & Office Services firms we cover. Despite KNL's 11% ROIC, above the 8% average of the peer group, the firm's stock trades at a discount to peers as shown by its position below the trend line in Figure 3. If the stock were to trade at parity with its peers, it would be at \$40/share – 68% above the current stock price. Given the firm's higher ROIC and impressive profit growth, one would think the stock would garner a premium valuation.

Figure 3: ROIC Explains 79% Of Valuation for Commercial & Office Services Firms

Sources: New Constructs, LLC and company filings

Leading Profitability Gives KNL A Competitive Advantage

In the commercial and residential furniture market, manufacturers compete largely on product design, quality, and price. Per Figure 4, KNL has the highest NOPAT margin and an equal ROIC versus peers, which include Herman Miller (MLHR), HNI Corporation (HNI), and Steelcase (SCS).

High margins allow KNL to invest more in market leading designs that meet the needs of a shifting mindset around workplace environments. At the same time, KNL's profitability gives it flexibility to better withstand changes in raw materials prices or a downturn in the economy. Most importantly, KNL is also able to provide products at a lower price than competitors while maintaining profitability, an effective way to take market share.

Figure 4: KNL's Top Profitability Among Competition

Company	Ticker	Return On Invested Capital	NOPAT Margin
Knoll Inc.	KNL	11%	8%
Herman Miller Inc.	MLHR	11%	6%
HNI Corporation	HNI	11%	6%
Steelcase Inc.	SCS	11%	5%

Sources: New Constructs, LLC and company filings.

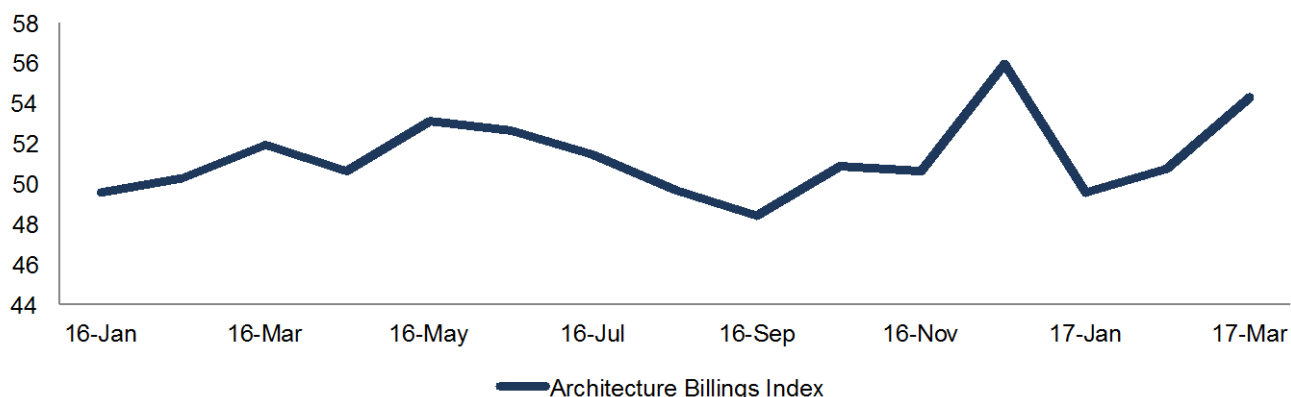
Bear Concerns Ignore Improving Market Conditions

As a provider of furniture and accessories to commercial office spaces, KNL is reliant upon corporate spending, a strong job market, and growing economy. After a weak 4Q16, bears will argue that KNL's best days are behind it. However, economic data, such as architecture billings, CEO confidence, and hiring plans, would show otherwise. Add in KNL's ability to keep costs low, and the bear case begins to look rather weak.

The weak 4Q16, in which KNL missed revenue expectations, can largely be attributed to the presidential election. Across the board, KNL and its peers pointed to uncertainty regarding the trajectory of the economy as causing a weak fourth quarter. However, this weakness appears to have subsided now that the election is over. Figure 5 shows that the [Architecture Billings Index](#), an indicator of nonresidential construction activity, has spiked in 1Q17. A score above 50 represents growth and March's ABI score of 54.3 is up from not only January and February of this year, but also March of 2016.

Figure 5: ABI Suggests Increased Business Construction

Architecture Billings Index Spikes in 2017



Sources: New Constructs, LLC and American Institute of Architects

Additionally, the CEO Confidence Index, which measures CEO's opinions on future economic and business conditions, reached 68 at the end of 1Q17. A score above 50 represents a positive opinion on the economy, and the 1Q17 score represents the highest rating since 2004. Furthermore, nearly two-thirds of those surveyed anticipate an increase in hiring in 2017, up from 30% of those surveyed in 2016. On the flip side, less than 10% expect a decrease in hiring in 2017, compared to 40% in 2016. Strong economic conditions bode well for KNL's growth potential.

Apart from macro economic trends, KNL has focused on improving profitability, with specific focus on its Office segment, which was 62% of revenue in 2016. From investments in sales capabilities to lean manufacturing initiatives, KNL has improved its Office segment operating margin from 6% in 2014 to 10% in 2016. Company



wide, the firm's operating costs, such as selling, general, and administrative, have grown in line with revenue compounded annually since 2013. Prudent cost management moving forward will allow KNL to take advantage of the improving market and capitalize on increased business spending.

Lastly, KNL's low valuation also undermines any bear argument. Despite rising sales, impressive NOPAT growth, and promising economic trends, KNL's current valuation implies meager profit growth expectations, as we'll show below.

Cheap Valuation Holds Significant Upside

Year-to-date, KNL is down 14% while the S&P is up 4%. This underperformance makes shares undervalued and presents a buying opportunity. At its current price of \$24/share, KNL has a price-to-economic book value ([PEBV](#)) ratio of 1.1. This ratio means the market expects KNL to grow NOPAT by no more than 10% over the remainder of its corporate life. This expectation seems at odds with a firm that has grown NOPAT by 7% compounded annually since 2004.

However, if KNL can maintain 2016 NOPAT margins (8%) and [grow NOPAT by 5% compounded annually for the next decade](#), the stock is worth \$31/share today – nearly 30% upside. This scenario assumes KNL can grow revenue by consensus estimates in 2017 (<1%) and 2018 (5%), and 5% each year thereafter. With non-residential construction activity trending higher, potential changes to corporate tax spurring investment, and margin improvement initiatives, KNL could easily meet or surpass these expectations. Add in the 2.5% dividend yield and its clear why KNL is on this month's [Most Attractive Stocks List](#) and could be an excellent portfolio addition.

Buy Backs Plus Dividend Could Yield 3%

In 2016, KNL repurchased over \$5 million worth of stock, down from nearly \$9 million in 2015. At the end of 2016, the company had over \$32 million remaining under its current authorization. Going forward, if KNL were to average its 2015 and 2016 repurchase activity, the firm could repurchase a total of \$7.1 million over four and half years. A repurchase of this size is 0.5% of the current market cap. When combined, Knoll's 0.5% repurchase yield and 2.5% dividend yield offer investors a total potential yield of 3%.

Market Overreaction Sets Up Earnings Beat Opportunity

When KNL reported 4Q16 earnings, the stock fell 15% the following week. As noted above, the firm missed revenue expectations and investors overreacted to one weak quarter caused by election uncertainty. When looking below the top line miss, the firm continued to improve its fundamentals, including profits, margins, and ROIC. However, consensus estimates were quickly cut, setting up a scenario in which KNL has a great opportunity to beat these lowered expectations.

In order to beat expectations, KNL has focused on building out its business beyond the Office segment. With acquisitions of DatesWeiser and Vladimir Kagan in 2016, KNL aims to provide a more diversified offering of luxury furnishings through its Studio segment, which was 28% of revenue in 2016. The Studio segment's operating margins of 17% are much greater than the Office segment so expanding this business line is key to growing profits.

Beating both top and bottom line expectations could be the catalyst that pushes the stock higher. When KNL reported 3Q16 results above consensus, the stock rose 11% over the next week. In 1Q16, when KNL again beat both top and bottom line expectations, the stock rose 7% in the following week.

With improving market conditions, including business activity and CEO confidence, and expansion of higher margin segments, KNL could be poised for another beat and subsequent increase in valuation. In the meantime, investors in this stock carry very low valuation risk and are rewarded with a potential 3% total yield given KNL's history of dividends and share repurchases.

Executive Compensation Plan Could Be Improved But Raises No Alarms

Carters' executive compensation plan, which includes base salary, annual incentives, and long-term incentives, is largely tied to multiple metrics. Annual bonuses are tied to operating profit and supplemental goals at the discretion of the compensation committee. Long-term incentives consist of time-based shares and performance-based restricted stock units. Performance-based shares are tied to three-year operating profit targets and total shareholder return. We would prefer to see executive compensation tied to ROIC, since there is a [strong correlation between ROIC and shareholder value](#). However, KNL's current exec comp plan has not led to



executives getting paid while destroying shareholder value. In fact, since 2010, Knoll's [economic earnings](#), the true cash flows of the business, have grown from \$15 million to \$40 million in 2016, a clear creation of shareholder value.

Insider Trends and Short Interest Are Minimal

Over the past 12 months, there have been 174 thousand insider shares purchased and 555 thousand insider shares sold. These sales represent 1% of shares outstanding. Additionally, short interest sits at 1.6 million shares, or 3% of shares outstanding.

Impact 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 Knoll's 2016 10-K:

Income Statement: we made \$46 million of adjustments, with a net effect of removing \$6 million in non-operating expense (1% of revenue). We removed \$20 million in [non-operating income](#) and \$26 million in [non-operating expenses](#). You can see all the adjustments made to KNL's income statement [here](#).

Balance Sheet: we made \$230 million of adjustments to calculate invested capital with a net increase of \$191 million. The largest adjustment was \$93 million due to [operating leases](#). This adjustment represented 15% of reported net assets. You can see all the adjustments made to KNL's balance sheet [here](#).

Valuation: we made \$412 million of adjustments with a net effect of decreasing shareholder value by \$412 million. There were no adjustments that increased shareholder value. Apart from [total debt](#), which includes the \$93 million in [operating leases](#) noted above, one of the notable adjustments was \$77 million in [net deferred tax liability](#). This adjustment represents 6% of KNL's market cap. Despite the net decrease in shareholder value, KNL remains undervalued.

Attractive Funds That Hold KNL

There are no funds that receive our Attractive-or-better rating and allocate significantly to Knoll Inc.

This article originally published on [April 24, 2017](#).

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

Follow us on [Twitter](#), [Facebook](#), [LinkedIn](#), and [StockTwits](#) for real-time alerts on all our research.



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](#).



DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.