New Stocks on Exec Comp & ROIC Model Portfolio: April 2017

Four new stocks make our Exec Comp Aligned With ROIC Model Portfolio this month. April's Exec Comp Aligned With ROIC Model Portfolio was made available to members on 4/13/17.

Recap from March's Picks

Our Exec Comp Aligned With ROIC Model Portfolio (-0.4%) outperformed the S&P 500 (-1.3%) last month. The best performing stock in the portfolio was Kimball International (KBAL), which was up 7%. Overall, eight out of the 15 Exec Comp To ROIC Stocks outperformed the S&P in March.

Since inception, this model portfolio is up 23% while the S&P 500 is up 11%.

The success of this Model Portfolio highlights the value of our robo-analyst technology that scales our forensic accounting expertise (featured in Barron's) across the footnotes in 10-Ks for 3000+ companies under coverage.

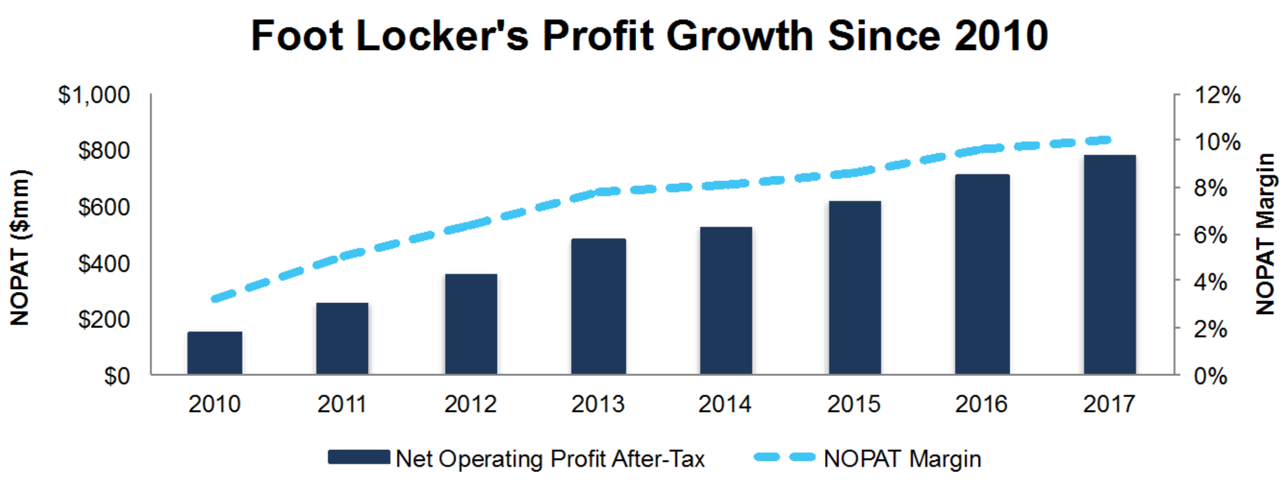
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas because return on invested capital (ROIC) is the primary driver of shareholder value creation.

New Stock Feature for April: Foot Locker, Inc. ($73/share)

Foot Locker (FL) is one of the additions to our Exec Comp Aligned With ROIC Model Portfolio in April. We featured Foot Locker in May 2015 when we highlighted its ability to consistently grow profits amidst retail competition. Since then, FL is up 14% while the S&P 500 is up 10% yet the stock remains undervalued.

Since 2010, Foot Locker has grown after-tax profit (NOPAT) by 26% compounded annually to $778 million in 2017. Per Figure 1, Foot Locker's NOPAT margin has grown from 3% in 2010 to 10% in 2017.

Figure 1: Foot Locker's Improving Profitability



Sources: New Constructs, LLC and company filings

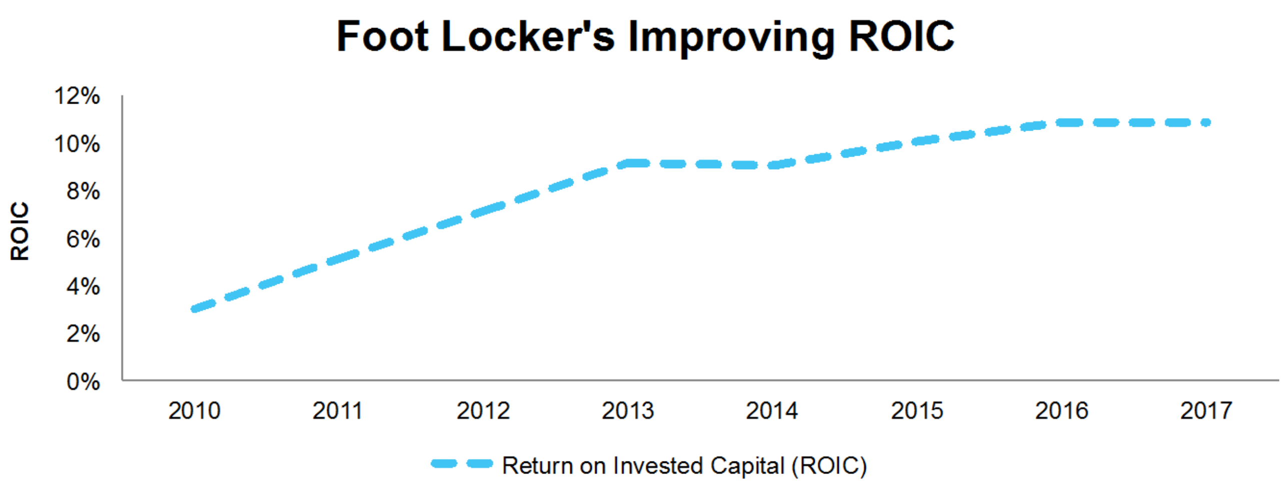
Foot Locker currently earns an 11% return on invested capital (ROIC) and has generated a cumulative $761 million (8% of market cap) in free cash flow over the past five years.

Executive Compensation Plan Incentivizes Shareholder Value Creation

Foot Locker has aligned executive compensation with ROIC since at least 1996, which is the earliest available electronic filing. In 2016, 30% of Foot Locker's long-term plan is tied to a two-year average ROIC. This long-term incentive plan represents 67% of the CEO's pay and 58% of other executives' pay.

The focus on ROIC helps ensure executives are good stewards of capital. Per Figure 2, Foot Locker has improved its ROIC from 3% in 2010 to 11% in 2017.

Figure 2: Improving ROIC Improves Shareholder Value



Sources: New Constructs, LLC and company filings

We have detailed ways in which ROIC is directly correlated to changes in shareholder value here. FL's use of return on invested capital to measure performance ensures executives' interests are aligned with shareholders' interests.

FL Is Undervalued Despite Strong Fundamentals

Investors have clearly rewarded Foot Locker for its improving fundamentals and the stock is up 135% over the past five years, while the S&P 500 is up 67%. Despite the increase in stock price, FL remains undervalued.

At its current price of $73/share, FL has a price to economic book value (PEBV) ratio of 0.7. This ratio means the market expects FL's NOPAT to permanently decline by 30%. This expectation seems rather pessimistic for a firm that has grown NOPAT by 26% compounded annually since 2010. Longer-term, FL has grown NOPAT by 5% compounded annually since 1998.

If Foot Locker can maintain current NOPAT margins (10%) and grow NOPAT by just 4% compounded annually over the next five years, the stock is worth $114/share today – a 56% 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 FL's 2017 10-K:

Income Statement: we made $352 million of adjustments, with a net effect of removing $114 million in non-operating expense (1% of revenue). We removed $119 million in non-operating income and $233 million in non-operating expenses. You can see all the adjustments made to FL's income statement here.

Balance Sheet: we made $6 billion of adjustments to calculate invested capital with a net increase of $3.9 billion. One of the largest adjustments was $3.5 billion due to operating leases. This adjustment represented 110% of reported net assets. You can see all the adjustments made to FL's balance sheet here.

Valuation: we made $4.5 billion of adjustments with a net effect of decreasing shareholder value by $3.1 billion. Apart from total debt, which includes the operating leases noted above, one of the largest adjustments to shareholder value was $664 million in excess cash. This adjustment represents 7% of FL's market cap. Despite the net decrease in shareholder value, FL remains undervalued.

This article originally published on April 18, 2017.

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

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.

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