



No Light at the End of the Tunnel for This Stock

Check out this week's [Danger Zone interview](#) with Chuck Jaffe of [Money Life](#).

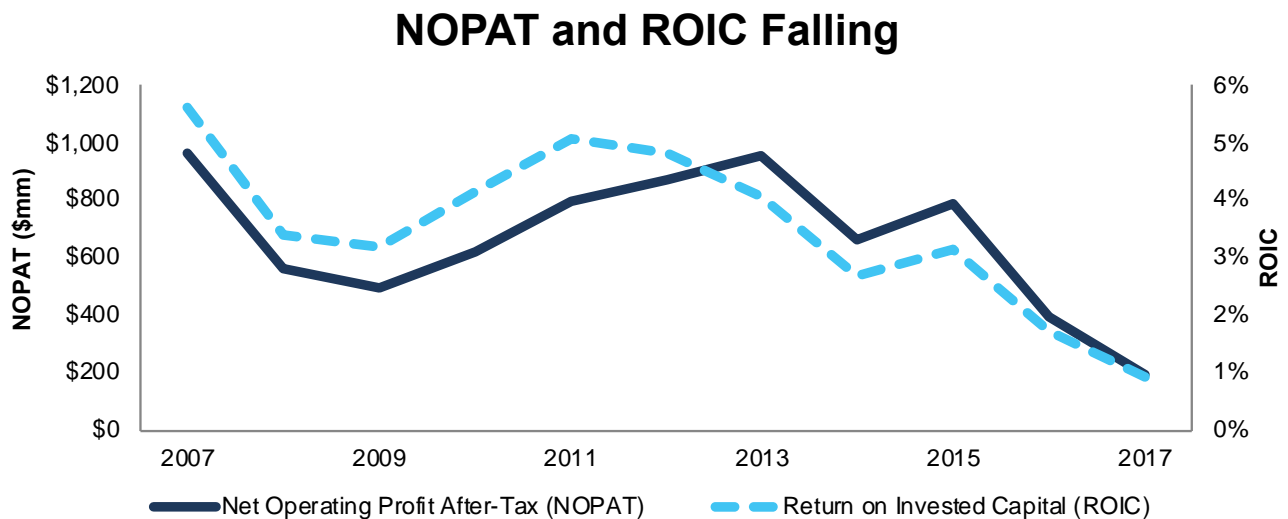
Investors will ignore a lot of red flags if they think they've found a diamond in the rough.

This company has an alarming number of red flags. Its shrinking cash flows can't cover its debt burden, its accounting is confusing and possibly unreliable, its industry faces technological disruption, and its valuation assumes implausibly high profit growth. These issues make Hertz Global Holdings (HTZ: \$20/share) this week's [Danger Zone](#) pick.

Long-Term Track Record of Profit Decline

Since 2007, after-tax profit ([NOPAT](#)) has fallen from \$960 million to \$196 million in 2017, and return on invested capital ([ROIC](#)) has fallen from 6% to 1%. Declining margins have been the primary culprit, with NOPAT margins falling from 11% to 2%.

Figure 1: HTZ's NOPAT and ROIC since 2007



Sources: New Constructs, LLC and company filings

Investors in Hertz are hoping for a turnaround, but so far there's been no sign that profits are stabilizing, much less returning to growth. Meanwhile, the company's debt burden continues to mount, with net debt hitting \$16.1 billion (84% of enterprise value) in 2017. The company's NOPAT has not been enough to cover its interest expense in each of the past two years.

Non-GAAP Accounting Misleads Investors & Raise Red Flags with Auditor

Hertz is a difficult stock for the average investor to evaluate because its GAAP net income number is functionally useless. The company's large debt load, frequent write-downs, unusual tax activity, and various other one-time items cause reported earnings to swing back and forth from positive to negative with no relation to the underlying economics of the business.

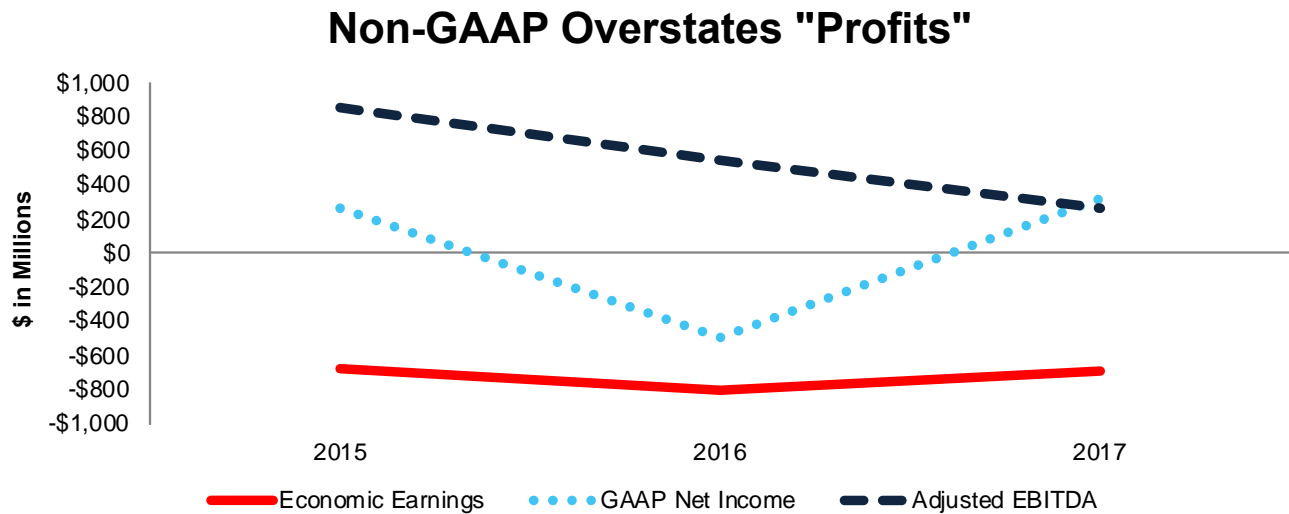
In 2017, Hertz's GAAP net income turned positive as a result of a [\\$679 million gain](#) from the remeasurement of its deferred tax liabilities after tax reform. In reality, as Figure 1 shows, Hertz's profitability continued its long-term decline.

Since GAAP numbers are even more misleading than normal for Hertz, investors pay more attention to non-GAAP metrics, especially adjusted EBITDA. Unfortunately, as shown in Figure 2, adjusted EBITDA significantly overstates the [economic earnings](#) of the business over the past three years (we don't have comparable adjusted



EBITDA numbers before 2015 due to accounting restatements and the spin-off of Hertz's equipment rental business).

Figure 2: HTZ's Non-GAAP Metrics Paint False Picture of Performance



Sources: New Constructs, LLC and company filings

Investors should be extra wary of Hertz's reported profits (both GAAP and non-GAAP) due to the company's history of accounting problems. In 2015, Hertz was forced to restate its earnings going back to 2011. One would imagine that such a significant problem would lead the company to emphasize accurate accounting going forward, but the company still has material weaknesses in its internal controls over reporting according to auditor PricewaterhouseCoopers. The inability (or lack of desire) to fix such a glaring problem poses a risk of further restatements and raises questions about management's ability to execute a turnaround.

Compensation Plan Rewards Execs for Non-GAAP Growth and Other Flawed Metrics

Hertz's executive compensation [misaligns executives' interests](#) with shareholders' interests. The misalignment helps drive the profit decline shown in Figure 1 and the disconnect between non-GAAP EBITDA and economic earnings.

80% of executives' long-term performance share units are awarded for meeting adjusted EBITDA and adjusted EBITDA margin targets. The remaining 20% is tied to improvements in net promoter score, a measure of customer satisfaction.

Tying executive compensation to adjusted EBITDA encourages wasteful investment and further accounting gimmickry. Executives can't be expected to be responsible stewards of shareholder capital if their performance incentives don't take capital allocation into account.

Tying compensation to customer satisfaction is a better idea since it targets an underlying driver of the business, but [multiple academic studies](#) have called into question the actual efficacy of net promoter score as a predictor of customer loyalty.

The bottom line is that improper incentives allow these execs to earn bonus awards while destroying shareholder value. We've demonstrated through [numerous case studies](#) that ROIC, not non-GAAP net income or similar metrics, is the [primary driver of shareholder value creation](#). A recent white paper published by Ernst & Young also validates the importance of ROIC (see here: [Getting ROIC Right](#)) and the superiority of our data analytics. Without major changes to this compensation plan (e.g. emphasizing ROIC), investors should expect further value destruction.



Falling Behind the Competition

Hertz is a global rental car company operating under the Hertz, Dollar, and Thrifty brands. Its primary business comes from airport rentals.

Hertz’s competitive position can be hard to analyze due to the fact that many of its competitors, both direct (Enterprise), and indirect (Uber, Lyft, etc.) are private companies. The only publicly traded competitor is Avis Budget Group (CAR).

Figure 3 compares Hertz and Avis on measures of profitability—ROIC, NOPAT margin, and average [invested capital turns](#) (revenue divided by average invested capital)—and revenue growth.

Figure 3: CAR Beats or Matches HTZ in All Categories

Company	ROIC	NOPAT Margin	Invested Capital Turns	Revenue Growth
Hertz	0.9%	2.2%	0.42	0.0%
Avis	2.8%	6.7%	0.42	2.2%

Sources: New Constructs, LLC and company filings

Not only is Avis more profitable than Hertz, it’s also taking market share, as evidenced by its growing revenue. Avis’ total rental days increased by 4% in 2017 versus a very slight decline for Hertz.

Hertz’s declining share and inferior margins put it in a tough competitive position. It can’t afford to cut prices to reverse the market share decline, and its significant debt load limits the amount it can invest in improving its service.

While we don’t have financial filings for Enterprise, available data shows it [increasing its industry-leading market share](#). Meanwhile, Uber and Lyft are [clearly cutting into the demand for rental cars](#), even if the exact size of their impact remains hard to quantify.

Hertz investors are betting that ridesharing companies will not cut into the demand for rental cars as much as the market expects. Unfortunately, even if the rental car business does survive this new competition, Hertz could be squeezed out by its more profitable competitors.

Bull Case Ignores Competitive Disadvantage

The bull case for Hertz largely centers on the potential value of the company’s fleet management system serving autonomous vehicles and ride-sharing services. The biggest recent boost to the stock came last June when the company [announced a partnership with Apple](#) (AAPL) to work on a small number of self-driving vehicles. The stock spiked 14% that day and wound up gaining over 200% over the next few months.

However, HTZ’s announcement came the same day that Waymo (GOOGL) and Avis announced a much larger deal. While Apple only leased six cars from Hertz, the Avis/Waymo deal covered 600 vehicles in a multi-year arrangement.

In addition, Waymo is a much more valuable partner in the self-driving vehicle space. A recent report by [Navigant Research](#) ranked Waymo as one of the leaders in self-driving vehicles. Apple, on the other hand, was a distant challenger.

It makes sense that Waymo would prefer to work with the more profitable company in Avis rather than Hertz, which is losing market share and still has the lack of credibility from its accounting issues.

While Hertz’s fleet management business has grown revenues in the single-digits over the past few years, it still only accounts for 8% of the company’s total sales. There’s no apparent catalyst for the fleet management business to produce the kind of dramatic gains necessary to offset the decline in the core rental business.

HTZ Is Priced for Perfection

Despite all its issues, HTZ is still up over 130% from its lows last June. Investors seem to be buying the turnaround story and the potential of the Apple partnership.



A look at the expectations baked into the company's stock price puts this optimism into perspective. To justify its price of \$20/share, HTZ would need to immediately achieve NOPAT margins of 6.7%, comparable to CAR, and [grow NOPAT by 11% compounded annually for 14 years](#).

Not only is that a high growth rate for a company with HTZ's track record, 14 years is also a long growth appreciation period ([GAP](#)) for a company facing such significant upheaval to its business. If we just shorten the GAP to 10 years, HTZ is worth \$5/share, a 73% downside from the current price.

Icahn Bailout Seems Unlikely

The other bull case for Hertz at its current valuation comes from the fact that activist investor Carl Icahn owns a 35% stake. The quickest route to profits for HTZ shareholders would be for Icahn to acquire the whole company.

The obvious flaw in this argument is that Icahn had a much more appealing opportunity to take Hertz private last summer when it was trading at \$9/share. If he wasn't willing to acquire the company at that price, it's hard to see why he'd do so now when the stock price has more than doubled.

At its current price of ~\$20/share, Hertz has an enterprise value of \$19.1 billion. This enterprise value includes:

1. \$1.9 billion in [off-balance sheet operating leases](#) (10% of enterprise value)
2. \$1.2 billion in [deferred tax liabilities](#) (6% of enterprise value)

Figure 4 shows the revenue growth scenarios Hertz would need to achieve for Icahn to earn a 4% ROIC (equal to Hertz's WACC) on the acquisition if we assume the company can match Avis' 6.7% NOPAT margin. This is essentially the break-even point for the deal to have any economic value.

Figure 4: Implied Acquisition Prices for Icahn to Achieve 4% ROIC

To Earn 4% ROIC On Acquisition		
Revenue Growth Scenario	HTZ's Implied Stock Value	% Discount to Current Price
2.5% CAGR for 5 years	(\$12)	N/A
5% CAGR for 5 years	\$12	39%

Sources: New Constructs, LLC and company filings.

The first scenario uses analyst projections for the first two years and a long-term revenue growth rate of 3.5%. If Hertz grows at this default rate for the next five years while achieving the same margins as Avis, it will not be worth acquiring at any price.

Even If Hertz can double that growth rate, it would only be worth acquiring at a 39% discount to the current stock price. That's a high hurdle for Icahn just to break even on a potential acquisition.

Further Accounting Issues or Fundamental Deterioration Could Send Shares Lower

Hertz faces a number of significant catalysts to send shares lower in 2018. As mentioned above, the company has had material weaknesses in its internal control over financial reporting for several years. Specifically, its auditor singled out the company's accounting for income taxes, which is a big concern given the complexity of accounting for tax reform.

Hertz will have more difficulty than most estimating the impact of tax reform due to its significant interest expense. The new law [caps the deductibility of interest at 30%](#) of EBITDA, which means Hertz will no longer be able to deduct a significant portion of its interest when accounting for its tax provision. The loss of this deduction will offset part of the reduced tax rate and limit the benefit to the company. If Hertz has overestimated the benefit when accounting for its deferred tax liabilities, it may be forced to take an additional loss in the coming quarters.

In addition, Hertz faces a challenging business environment. The company relies on selling off older vehicles in its fleet as they become obsolete. 2018 is projected to see a [large increase in vehicles coming off-lease](#), which will push down prices in the used car market and will put more pressure on the company's already slim margins.

Not only could these issues hurt the company's cash flows, they could also lead to significant write-downs of either the company's vehicle inventory or its \$4.3 billion (22% of total assets) in goodwill and other intangible assets.



Minimal Insider Trading and Significant Short Interest

Over the past 12 months, 101 thousand insider shares have been purchased and 41 thousand have been sold for a net effect of 60 thousand insider shares purchased. These purchases represent less than 1% of shares outstanding.

Short interest is currently 19.3 million shares, which equates to 23% of shares outstanding and six days to cover. The significant short interest does increase the probability of a short squeeze and probably contributed to the significant run-up in the stock last year.

Auditable Impact of Footnotes & Forensic Accounting Adjustments¹

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 Hertz's 2017 10-K:

Income Statement: we made \$1.9 billion of adjustments, with a net effect of removing \$131 million in non-operating income (1% of revenue). We removed \$1 billion in [non-operating income](#) and \$895 million in [non-operating expenses](#). You can see all the adjustments made to HTZ's income statement [here](#).

Balance Sheet: we made \$4.4 billion of adjustments to calculate invested capital with a net increase of \$3.1 billion. One of the largest adjustments was \$1.8 billion in [accumulated asset write-downs](#). This adjustment represented 10% of reported net assets. You can see all the adjustments made to HTZ's balance sheet [here](#).

Valuation: we made \$18.7 billion of adjustments with a net effect of decreasing shareholder value by \$17.4 billion. In addition to the debt and deferred tax liabilities mentioned above, we subtracted \$105 million (6% of market cap) for [underfunded pensions](#).

Unattractive Funds That Hold HTZ

The following funds receive our Unattractive-or-worse rating and allocate significantly to Hertz.

1. State Street SPDR S&P Transportation ETF – 2.8% allocation and Unattractive rating
2. Rational Hedged Return Fund – 2% allocation and Very Unattractive rating

This article originally published on [March 12, 2018](#).

Disclosure: David Trainer, Kyle Guske II, and Sam McBride 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.

¹ Ernst & Young's recent white paper, "[Getting ROIC Right](#)", proves the superiority of our research and analytics.



New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide [tangible, quantifiable correlation](#) to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our [robo-analyst technology](#) empowers us to perform for thousands of stocks, ETFs and mutual funds.



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.