



Featured Stocks in May's Exec Comp & ROIC Model Portfolio

Three new stocks make May's Exec Comp Aligned with ROIC Model Portfolio, available to members as of May 16, 2018.

Recap from April's Picks

Our Exec Comp Aligned with ROIC Model Portfolio (+0.6%) underperformed the S&P 500 (+2.8%) last month. The best performing stock in the portfolio was Nautilus Group (NLS), which was up 15%. Overall, four out of the 15 Exec Comp Aligned with ROIC Stocks outperformed the S&P in April, and seven had positive returns.

Since inception, this model portfolio is up 27% while the S&P 500 is up 26%.

The success of this Model Portfolio highlights the value of our [Robo-Analyst technology](#)¹, which scales our forensic accounting expertise ([featured in Barron's](#)) across thousands of stocks.

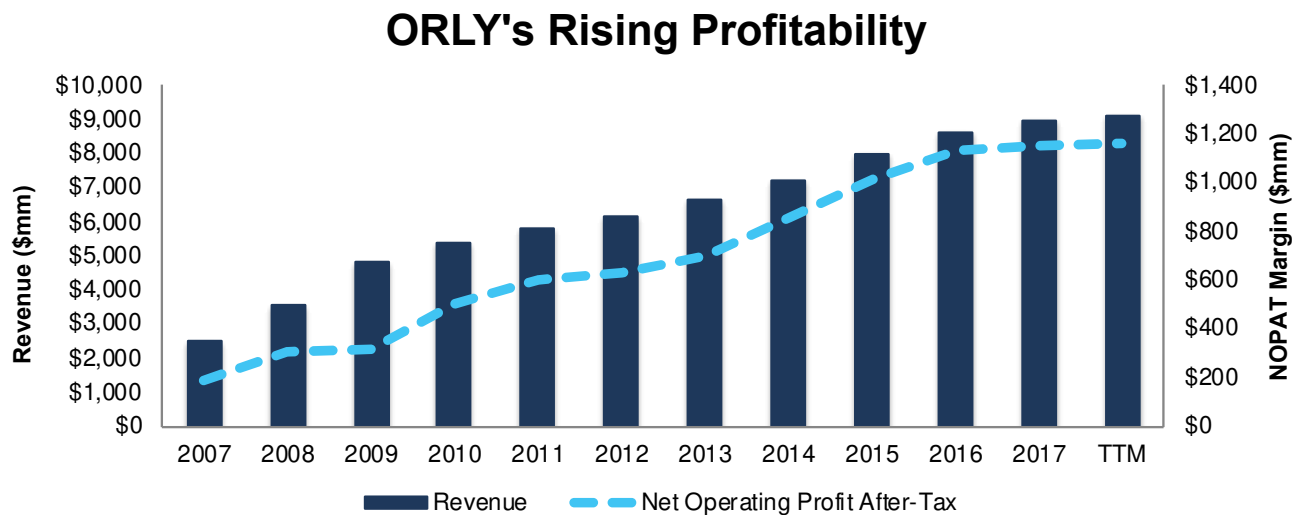
This Model Portfolio only includes stocks that earn an [Attractive or Very Attractive](#) rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas because return on invested capital (ROIC) is the [primary driver of shareholder value creation](#).²

New Stock Feature for May: O'Reilly Automotive, Inc. (ORLY: \$272/share)

O'Reilly Automotive (ORLY), an automotive aftermarket parts retailer, is the featured stock in May's Exec Comp Aligned with ROIC Model Portfolio.

Over the past decade, ORLY has grown revenue by 14% compounded annually and after-tax operating profit (NOPAT) by 20% compounded annually. ORLY has managed to grow profits faster than revenue by increasing its NOPAT margin from 8% in 2007 to 13% over the last twelve months. Further highlighting the strength of its business, ORLY has generated cumulative free cash flow (FCF) of \$4.1 billion (18% of market cap) over the past five years.

Figure 1: ORLY's Revenue & NOPAT Since 2007



Sources: New Constructs, LLC and company filings

¹ Harvard Business School features the powerful impact of our research automation technology in the case [New Constructs: Disrupting Fundamental Analysis with Robo-Analysts](#).

² Ernst & Young's recent white paper, "[Getting ROIC Right](#)", proves the superiority of our research and analytics.



Executive Compensation Plan Helps Drive Shareholder Value Creation

O'Reilly has included ROIC as a performance metric in its executive compensation plan since 2013. In 2017, 20% of annual incentive compensation awards were tied to ROIC. This focus on ROIC has led to O'Reilly's ROIC improving from 12% in 2012 (year before ROIC was added) to 21% TTM. O'Reilly's exec comp plan lowers the risk of investing in the company's stock because know executives are held accountable for creating real profits.

Valuation Still Provides Upside Potential

Despite the strong fundamentals, ORLY is up just 4% over the past four years while the S&P 500 is up 30%. At its current price of \$272/share, ORLY has a price-to-economic book value ([PEBV](#)) ratio of 1.3. This ratio means the market expects ORLY's NOPAT to grow by no more than 30% over the remaining life of the firm. This expectation seems rather conservative give O'Reilly has grown NOPAT by 20% compounded annually since 1998.

If ORLY can maintain TTM margins (13%) and grow NOPAT by just 5% compounded annually for the next decade, the stock is worth \$329/share today – a 20% upside. [See the math behind this dynamic DCF scenario here.](#)

ORLY is more expensive than the companies we usually feature, which tend to have a PEBV of 1.2 or below. However, as [Warren Buffett once wrote](#), "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

Critical Details Found in Financial Filings By Our [Robo-Analyst Technology](#)

As investors [focus more](#) on fundamental research, research automation technology is needed to analyze all the critical financial [details in financial filings](#). Below are specifics on the adjustments we make based on Robo-Analyst findings in O'Reilly Automotive's 2017 10-K:

Income Statement: we made \$352 million of adjustments, with a net effect of removing \$16 million in non-operating expense (<1% of revenue). We removed \$168 million in [non-operating income](#) and \$184 million in [non-operating expenses](#). You can see all the adjustments made to ORLY's income statement [here](#).

Balance Sheet: we made \$1.9 billion of adjustments to calculate invested capital with a net increase of \$1.7 billion. One of the largest adjustments was \$1.8 billion due to [operating leases](#). This adjustment represented 47% of reported net assets. You can see all the adjustments made to ORLY's balance sheet [here](#).

Valuation: we made \$5.1 billion of adjustments with a net effect of decreasing shareholder value by \$5.1 billion. There were no adjustments that increased shareholder value. Apart from \$5 billion in [total debt](#), which includes the [operating leases](#) noted above, one of the largest adjustments to shareholder value was \$90 million in [deferred tax liabilities](#). This adjustment represents <1% of ORLY's market cap. Despite the net decrease in shareholder value, ORLY remains undervalued.

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

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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.



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