Featured Stocks in July's Safest Dividend Yields Model Portfolio

Three new stocks make our Safest Dividend Yield Model Portfolio this month, which was made available to members on July 20, 2018.

Recap from June's Picks

Our Safest Dividend Yield Model Portfolio underperformed the S&P 500 last month. The Model Portfolio fell 0.6% on a price return basis and rose 0.2% on a total return basis. The S&P 500 rose 1.8% on a price and total return basis. The best performing stocks in the portfolio were large cap stock Anheuser-Busch InBev (BUD), which was up 6%, and small cap stock, Ennis Inc. (EBF), which was up 15%. Overall, eight out of the 20 Safest Dividend Yield stocks outperformed the S&P in July.

This Model Portfolio leverages our Robo-Analyst technology[1], which scales our forensic accounting expertise (featured in Barron's) across thousands of stocks.[2]

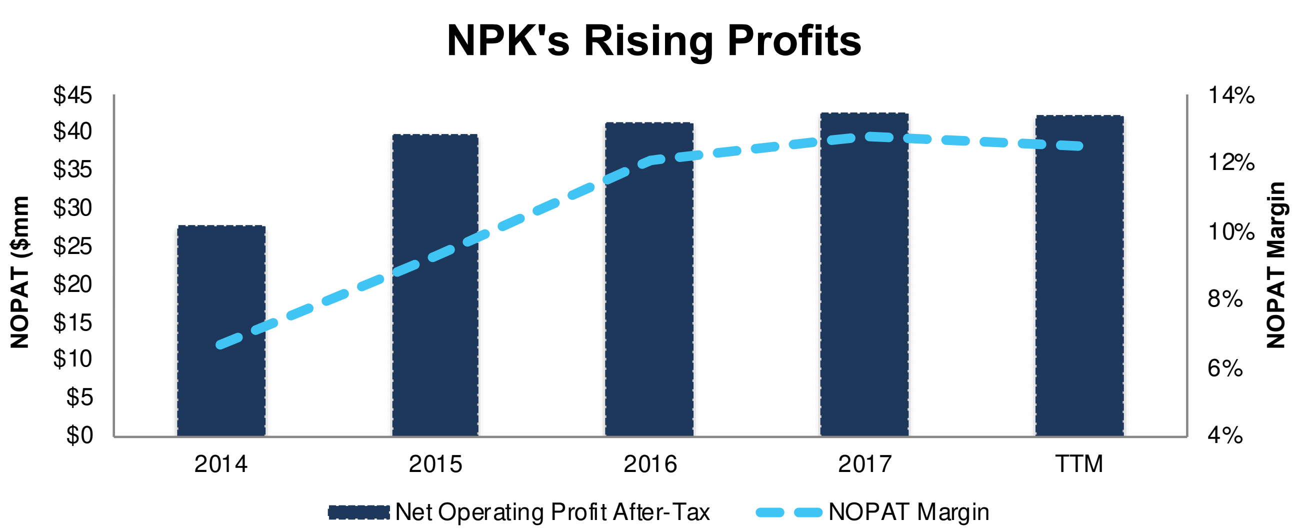
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating, have positive free cash flow and economic earnings, and offer a dividend yield greater than 3%. Companies with strong free cash flow provide higher quality and safer dividend yields because we know they have the cash to support the dividend. We think this portfolio provides a uniquely well-screened group of stocks that can help clients outperform.

Featured Stock for July: National Presto Industries (NPK: $120/share)

National Presto Industries (NPK), a small appliance and defense products manufacturer, is the featured stock in July's Safest Dividend Yields Model Portfolio. NPK was also featured as a Long Idea in June 2018.

Since 2014, NPK has grown after-tax operating profit (NOPAT) by 16% compounded annually. NOPAT margin has increased from 7% in 2014 to 13% TTM while return on invested capital (ROIC) has improved from 9% to a top-quintile 21% over the same time. As we noted in our Long Idea, the strength of NPK's Defense segment is actually masked by the weaker Housewares segment, and NPK could unlock significant value by spinning off this segment.

Figure 1: NPK NOPAT and Margin Since 2014



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 holdings research and analytics.

NPK's Free Cash Flow Supports Dividend Payments

NPK's regular annual dividend has been maintained at $1/share for reach of the past five years. Over this time, the company has regularly paid special dividends ranging from $3.05/share to $5/share. This dividend payment (regular and special) has been supported by NPK's free cash flow. Since 2013, NPK has generated a cumulative $185 million (22% of market cap) in FCF while paying $137 million in dividends.

Companies with strong free cash flow provide higher quality dividend yields because we know the firm has the cash to support its dividend. On the flip side, dividends from companies with low or negative free cash flow cannot be trusted as much because the company may not be able to sustain paying dividends.

Valuation Implies No Future Profit Growth

At its current price of ~$120/share, NPK has a PEBV of 1.0, which implies that the market expects NOPAT to remain flat and never grow from current levels. This pessimistic expectation is unwarranted, especially when one considers the significant tax cut NPK is set to receive. If NPK can reduce its cash tax rate to the new statutory rate of 21% (from 33%) it can generate 18% more NOPAT and increase its NOPAT margin from 13% to 15%.

If NPK sells the Housewares segment this year, and the Defense business grows revenues at a long-term rate of 4% compounded annually for the next ten years, while maintaining its pretax margin of 23% and benefitting from a reduction of its tax rate to 21%, the stock is worth $171/share today, 43% above the current share price. See the math behind this dynamic DCF scenario.

We think NPK would be better off selling its Housewares segment, but even if the company keeps the businesses together, it should still be able to exceed the low expectations implied by its stock price.

Even if we project the decline in Housewares to be a drag on NPK's pre-tax margin and revenue growth, the stock still has significant long-term value. If pre-tax margins for the company fall from 19% to 18%, and revenue grows by 3% compounded annually for the next decade, the stock is worth $161/share, 34% above the current stock price. See the math behind this dynamic DCF scenario.

Critical Details Found in Financial Filings y 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 National Presto Industries' 2017 10-K:

Income Statement: we made $16 million of adjustments, with a net effect of removing $10 million in non-operating expense (3% of revenue). We removed $13 million in non-operating income and $3 million in non-operating expenses. You can see all the adjustments made to NPK's income statement here.

Balance Sheet: we made $167 million of adjustments to calculate invested capital with a net decrease of $125 million. The largest adjustment was $139 million (38% of net assets) in excess cash. See all adjustments to NPK's balance sheet here.

Valuation: we made $144 million of adjustments with a net effect of increasing shareholder value by $143 million. Apart from the excess cash noted above, the largest $4 million from discontinued operations. This adjustment represents less than 1% of NPK's market value.

This article originally published on July 24, 2018.

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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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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