Featured Stock in February's Dividend Growth Model Portfolio

18 new stocks make our Dividend Growth Stocks Model Portfolio this month, which was made available to members on February 27, 2019.

The long-term success of our model portfolio strategies highlights the value of our Robo-Analyst technology[1], which scales our forensic accounting expertise (featured in Barron's) across thousands of stocks[2].

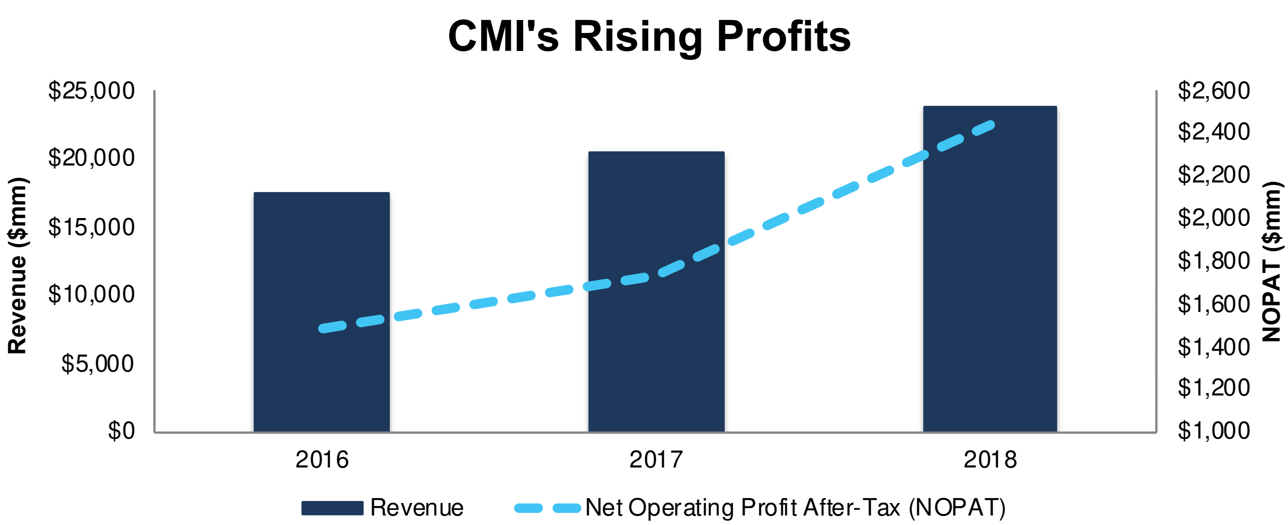
The methodology for this model portfolio mimics an All-Cap Blend style with a focus on dividend growth. Selected stocks earn an Attractive or Very Attractive rating, generate positive free cash flow (FCF) and economic earnings, offer a current dividend yield >1%, and have a 5+ year track record of consecutive dividend growth. This model portfolio is designed for investors who are more focused on long-term capital appreciation than current income, but still appreciate the power of dividends, especially growing dividends.

Featured Stock from February: Cummins Inc. (CMI: $154/share)

Cummins Inc. (CMI) is the featured stock from February's Dividend Growth Stocks Model Portfolio. We also featured CMI as a Long Idea in November 2018.

Since 2016, CMI has grown revenue by 17% compounded annually and after-tax operating profit (NOPAT) by 28% compounded annually. NOPAT margin has increased from 8% in 2016 to 10% in 2018 while return on invested capital (ROIC) has improved from 12% to 16% over the same time.

Figure 1: CMI Profit Growth Since 2016



Sources: New Constructs, LLC and company filings

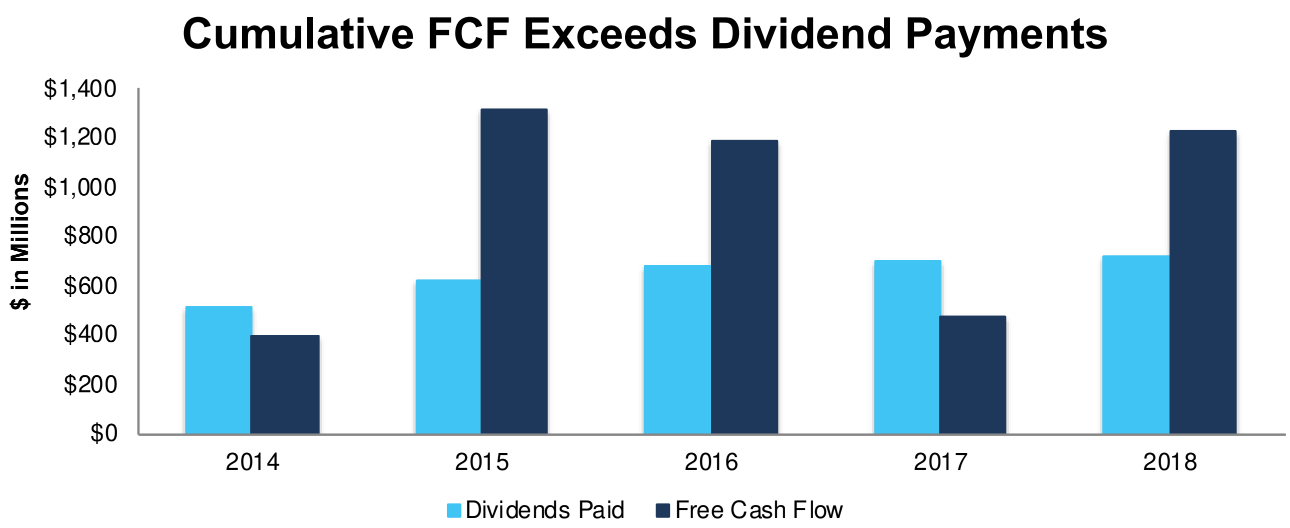
[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.
[2] Ernst & Young's recent white paper "Getting ROIC Right" demonstrates the superiority of our stock research and analytics.

CMI's Free Cash Flow Supports Dividend Growth

Cummins has increased its annual dividend in each of the last nine years. CMI's annual dividend has grown from $2.81/share in 2014 to $4.44/share in 2018, or 12% compounded annually. Positive free cash flow fueled dividend growth in the past and should continue to do so in the future. Since 2014, CMI has generated cumulative FCF of $4.6 billion (19% of market cap) while paying $3.2 billion in dividends.

Companies with FCF well in excess of dividend payments provide higher quality dividend growth opportunities because we know the firm generates the cash to support a higher dividend. On the other hand, the dividend of a company where FCF falls short of the dividend payment over time cannot be trusted to grow or even stay the same because of inadequate free cash flow.

Figure 2: Free Cash Flow (FCF) vs. Regular Dividend Payments



Sources: New Constructs, LLC and company filings

CMI Holds Significant Upside Potential

At its current price of $154/share, CMI has a price-to-economic book value (PEBV) ratio of 0.8. This ratio means the market expects CMI's NOPAT to permanently decline by 20%. This expectation seems overly pessimistic for a firm that has grown NOPAT by 28% compounded annually since 2016 and 11% compounded annually over the past decade.

If CMI can maintain current NOPAT margins (10%) and grow NOPAT by just 2% compounded annually for the next decade, the stock is worth $205/share today – a 33% upside. Click here to see the math behind this dynamic DCF scenario. Add in CMI's 3% dividend yield and history of dividend growth, and it's clear why this stock is in February's Dividend Growth Stocks Model Portfolio.

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 Cummins' 2018 10-K:

Income Statement: we made $990 million of adjustments with a net effect of removing $302 million in non-operating expense (2% of revenue). See all adjustments made to CMI's income statement here.

Balance Sheet: we made $5.6 billion of adjustments to calculate invested capital with a net increase of $2.2 billion. The most notable adjustment was $1.8 billion (14% of reported net assets) related to other comprehensive income. See all adjustments to CMI's balance sheet here.

Valuation: we made $4.8 billion of adjustments with a net effect of decreasing shareholder value by $3.4 billion. Apart from $3.1 billion in total debt, which includes $437 million in off-balance sheet operating leases, the largest adjustment to shareholder value was $911 million in minority interests. This adjustment represents 4% of CMI's market value. See all adjustments to CMI's valuation here. Despite these subtractions from shareholder value, CMI remains undervalued.

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Disclosure: David Trainer and Kyle Guske II 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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