Featured Stock in April's Dividend Growth Model Portfolio

11 new stocks make our Dividend Growth Stocks Model Portfolio this month, which was made available to members on April 26, 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].

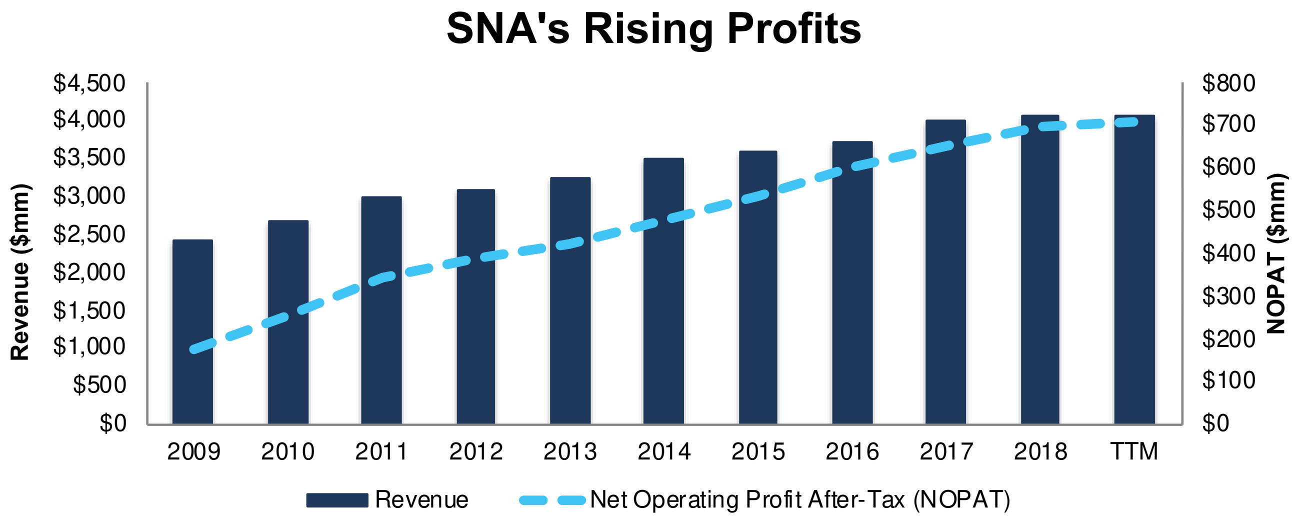
The methodology for this model portfolio mimics an All-Cap Blend style with a focus on dividend growth. Selected stocks earn an Attractive or Very Attractive rating, generate positive free cash flow (FCF) and economic earnings, offer a current dividend yield >1%, and have a 5+ year track record of consecutive 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 April: Snap-On Inc. (SNA: $168/share)

Snap-On (SNA) is the featured stock from April's Dividend Growth Stocks Model Portfolio. Snap-On was previously made a Long Idea in February 2018 and still earns our Attractive rating.

Since 2009, SNA has grown after-tax profit (NOPAT) by 17% compounded annually, to $699 million in 2018. Over the same time, NOPAT margin improved from 7% in 2009 to 17% TTM while its return on invested capital (ROIC) improved from 7% to 14%. The company has also generated free cash flow of $1.4 billion (15% of market cap) over the past five years.

Figure 1: SNA's Revenue and NOPAT Since 2009



Sources: New Constructs, LLC and company filings

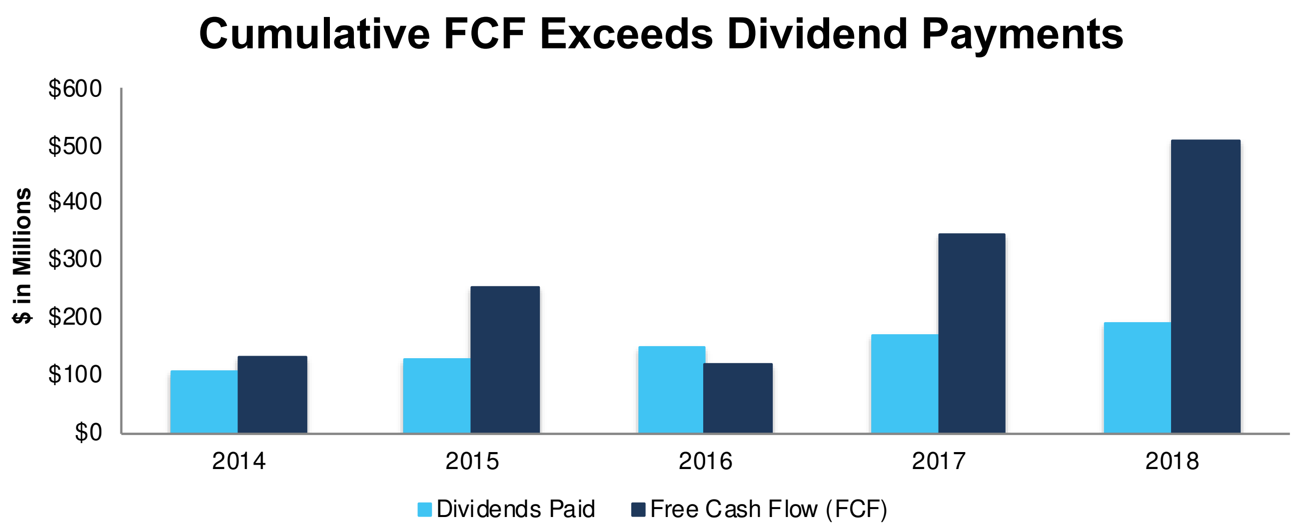
[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.
[2] Ernst & Young's recent white paper "Getting ROIC Right" demonstrates the superiority of our stock research and analytics.

Steady Dividend Growth Supported by FCF

Snap-On has increased its annual dividend each of the past 10 years. SNA's annual dividend has grown 17% compounded annually, from $1.85/share in 2014 to $3.41/share in 2018. Most importantly, SNA easily generates the cash flow needed to continue paying and growing its dividend. Over the past five years, SNA has generated a cumulative $1.4 billion in FCF while paying $744 million 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

SNA Holds Significant Upside Potential

At its current price of $168/share, SNA has a price-to-economic book value (PEBV) ratio of 1.0. This ratio means the market expects SNA's NOPAT to never grow from its current level. This expectation seems overly pessimistic for a firm that has grown NOPAT by 18% compounded annually since 1998.

If SNA can maintain current NOPAT margins (17%) and grow NOPAT by just 4% compounded annually over the next decade, the stock is worth $204/share today – a 21% upside. See the math behind this dynamic DCF scenario. Add in Snap-On's 2.3% dividend yield and history of dividend growth, and it's clear why this stock is in April'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 Snap-On's 2018 10-K:

Income Statement: we made $156 million of adjustments with a net effect of removing $19 million in non-operating expense (<1% of revenue). See all adjustments made to SNA's income statement here.

Balance Sheet: we made $1.2 billion of adjustments to calculate invested capital with a net increase of $699 million. The most notable adjustment was $487 million (11% of reported net assets) related to other comprehensive income. See all adjustments to SNA's balance sheet here.

Valuation: we made $1.6 billion of adjustments with a net effect of decreasing shareholder value by $1.4 billion. Apart from $1.2 billion in total debt, which include off-balance sheet operating leases, the largest adjustment to shareholder value was $206 million in underfunded pensions. This adjustment represents 2% of SNA's market value. See all adjustments to SNA's valuation here.

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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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