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STOCK PICKS AND PANS
5/23/19

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

Two new stocks make May's Exec Comp Aligned with ROIC Model Portfolio, available to members as of May 15, 2019.

Get the best fundamental research

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.

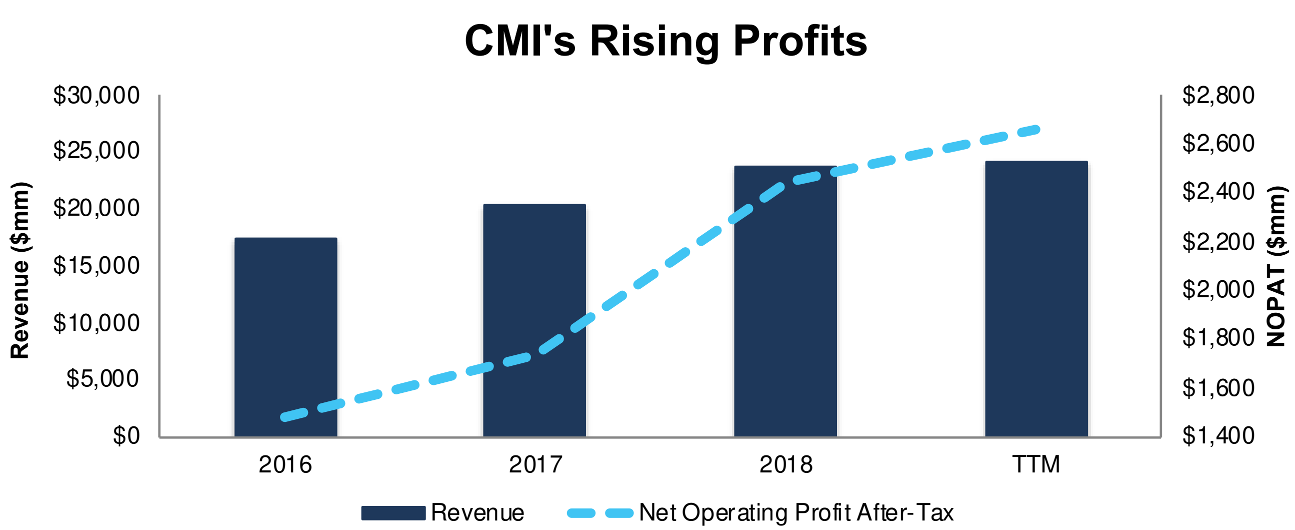
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas because return on invested capital (ROIC) is the primary driver of shareholder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

New Stock Feature for May: Cummins Inc. (CMI: $164/share)

Cummins Inc. (CMI) is the featured stock in May's Exec Comp Aligned with ROIC Model Portfolio. We made CMI a Long Idea in November 2018. The stock is up 12% since our report and has outperformed the market (S&P +7%).

Since 2016, CMI has grown revenue by 17% compounded annually and after-tax operating profit (NOPAT) by 28% compounded annually. CMI's trailing twelve month (TTM) NOPAT of $2.7 billion is up 47% year-over-year. The company's NOPAT margin has increased from 8% in 2016 to 11% TTM while return on invested capital (ROIC) has improved from 12% to 17% 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.

Executive Compensation Plan Helps Drive Shareholder Value Creation

At the beginning of 2018, CMI's board replaced replace return on equity (ROE) with ROIC as the target for its long-term incentives.

We applaud this shift, as ROE is not as reliable a metric for investors. It can be distorted by leverage, which is Cummins' reason for making the change, but it also relies on flawed accounting earnings and ignores off-balance sheet items. ROIC is a superior metric that has a much more significant link to valuation.

Under the new compensation plan, 80% of long-term executive compensation will be linked to ROIC. This focus on improving ROIC will align the interests of executives and shareholders and ensure prudent stewardship of capital. There is also a strong correlation between improving ROIC and increasing shareholder value, a fact highlighted in our recent article "CEO's That Focus on ROIC Outperform."

CMI Provides Significant Upside Potential

At its current price of $164/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 (11%) and grow NOPAT by just 3% compounded annually for the next decade, the stock is worth $201/share today – a 23% upside. See the math behind this dynamic DCF scenario.

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 (1% of revenue). You can see all the 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. One of the largest adjustments was $1.8 billion in other comprehensive income. This adjustment represented 14% of reported net assets. You can see all the adjustments made to CMI's balance sheet here.

Valuation: we made $4.6 billion of adjustments with a net effect of decreasing shareholder value by $3.2 billion. Apart from total debt, which includes $437 million in operating leases, the largest adjustments to shareholder value was $907 million in minority interests. This adjustment represents 4% of CMI's market cap. See all adjustments to CMI's valuation here. Despite these subtractions from shareholder value, CMI remains undervalued.

This article originally published on May 23, 2019.

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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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.

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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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