Featured Stock in September's Dividend Growth Model Portfolio

Five new stocks make our Dividend Growth Stocks Model Portfolio this month, which was made available to members on September 26, 2019.

Recap from August's Picks

Our Dividend Growth Stocks Model Portfolio outperformed the S&P 500 from August 29, 2019 through September 24, 2019. The Model Portfolio rose 3.5% on a price return basis and 3.7% on a total return basis. The S&P 500 rose 1.1% on a price return basis and 1.6% on a total return basis. The portfolio's best performing stock was up 14%. Overall, 21 out of the 30 Dividend Growth Stocks outperformed the S&P from August 29, 2019 through September 24, 2019, and 24 had positive returns.

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 September: Best Buy Co. (BBY: $69/share)

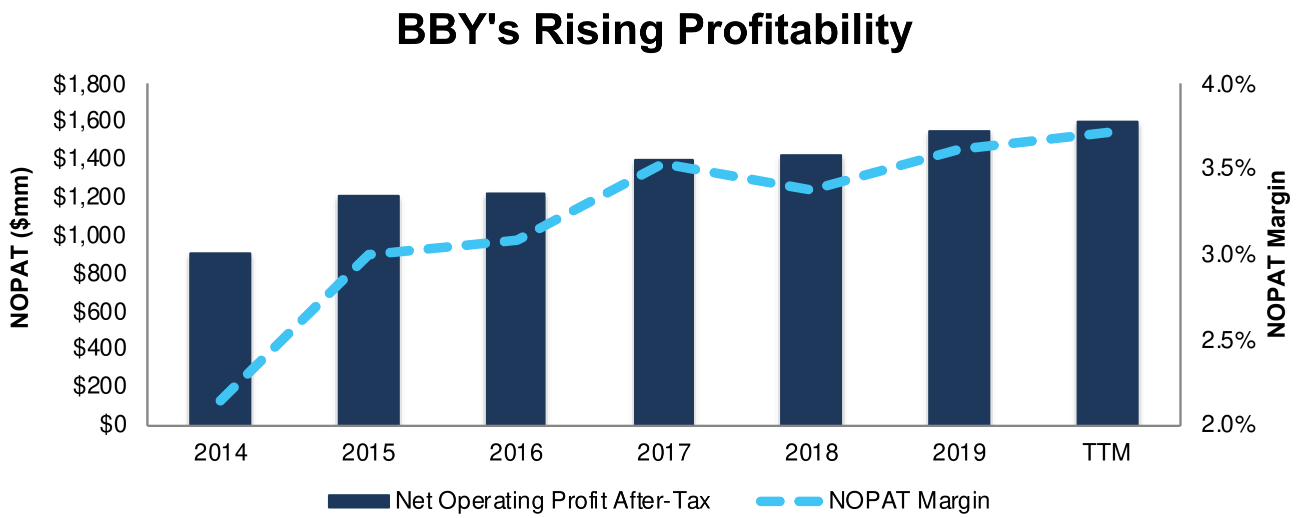
Best Buy (BBY) is the featured stock from September's Dividend Growth Stocks Model Portfolio. We also made BBY a Long Idea in April 2018 and the stock remains undervalued.

Since fiscal 2014, BBY has grown after-tax operating profit (NOPAT) by 11% compounded annually. BBY's trailing twelve months (TTM) NOPAT of $1.6 billion is up 11% over the prior TTM period. BBY's NOPAT margins are up from 2% in fiscal 2014 to 4% TTM and its return on invested capital (ROIC) has also improved from 7% to 17% over the same time.

[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] This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Figure 1: BBY NOPAT & NOPAT Margin Since Fiscal 2014



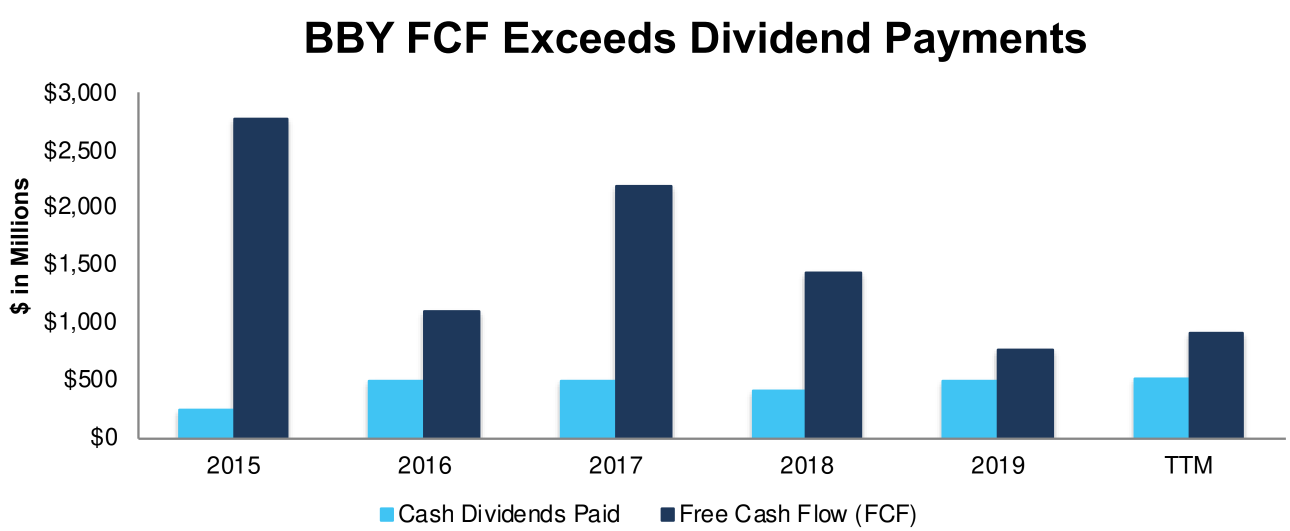
Sources: New Constructs, LLC and company filings

Steady Dividend Growth Supported by FCF

Best Buy has increased its annual dividend in each year since 2010. The regular annual dividend (excluding special dividends) has grown from $0.72/share in 2015 to $1.95/share in TTM, or 22% compounded annually. BBY easily generates the cash flow needed to continue paying and growing its dividend. From 2015-2019, BBY generated cumulative FCF of $8.3 billion (45% of market cap) while paying $2.2 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

BBY Holds Significant Upside Potential

At its current price of $69/share, BBY has a price-to-economic book value (PEBV) ratio of 0.9. This ratio means the market expects BBY's NOPAT to permanently decline by 10%. This expectation seems rather pessimistic for a firm that has grown NOPAT by 11% compounded annually since fiscal 2014 and 12% compounded annually over the past two decades.

If BBY can maintain 2018 margins of 4% and grow NOPAT by just 3% compounded annually for the next decade, the stock is worth $84/share today – a 22% upside. See the math behind this dynamic DCF scenario. Add in BBY's 2.9% dividend yield and history of dividend growth, and it's clear why this stock is in September'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 Best Buy's fiscal 2019 10-K:

Income Statement: we made $513 million of adjustments, with a net effect of removing $85 million in non-operating expenses (<1% of revenue). You can see all the adjustments made to BBY's income statement here.

Balance Sheet: we made $6 billion of adjustments to calculate invested capital with a net increase of $4.1 billion. One of the largest adjustments was $2.5 billion due to operating leases. This adjustment represented 47% of reported net assets. You can see all the adjustments made to BBY's balance sheet here.

Valuation: we made $3.7 billion of adjustments with a net effect of decreasing shareholder value by $3.7 billion. Apart from $3.6 billion in total debt, which includes the operating leases noted above, the largest adjustment to shareholder value was $60 million in outstanding employee stock options. This option adjustment represents <1% of BBY's market cap. See all adjustments to BBY's valuation here.

This article originally published on October 2, 2019.

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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