New Constructs®
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DANGER ZONE
1/31/22

Falling Knife You Don't Want to Catch – Part 5

We counsel investors to take care not to be cut by falling knives – stocks that have seen steep declines but still have further to fall. As the market rotates away from high-flying growth names to more stable cash generators, investors need reliable fundamental research, more than ever, to protect their portfolios from falling knives.

We continue to post an exceptional hit rate on spotting overvalued stocks. Currently, 62 out of our 65 Danger Zone stock picks are down from their 52-week highs by more than the S&P 500. Figure 1 lists the open Danger Zone picks that are down at least 40% from their 52-week highs. Our Focus List Stocks: Short Model Portfolio, the best-of-the-best of our Danger Zone picks, outperformed the S&P 500 as a short portfolio by 36% in 2021 with 29 out of our 31 picks outperforming the index.

This report highlights one particularly dangerous falling knife: Warby Parker (WRBY: $35/share). We highlight four other falling knives in other reports published today: Uber (UBER: $35/share) here, Affirm (AFRM: $60/share) here, Rivian (RIVN: $60/share) here, and DoorDash (DASH: $104/share) here. Each of these stocks have dropped at least 40% from all-time highs, yet still carry at least 40% additional downside risk.

Figure 1: Danger Zone Picks Down >40% From 52-Week High – Performance through 1/28/22

Company	Ticker	Off 52-Week High
Koss Corp	KOSS	-94%
Robinhood Markets Inc.	HOOD	-85%
Peloton Interactive Inc.	PTON	-84%
GameStop Corporation	GME	-80%
AMC Entertainment Holdings, Inc.	AMC	-79%
Cronos Group Inc.	CRON	-78%
Beyond Meat Inc.	BYND	-71%
Pinterest Inc.	PINS	-70%
Rivian Automotive Inc	RIVN	-68%
Express Inc.	EXPR	-68%
Affirm Holdings Inc.	AFRM	-66%
Allbirds Inc	BIRD	-64%
Snap Inc.	SNAP	-63%
LivePerson Inc.	LPSN	-63%
Carvana Co.	CVNA	-61%
DoorDash, Inc.	DASH	-60%
Wayfair, Inc.	W	-59%
Coinbase Global Inc.	COIN	-59%
Spotify Technology S.A.	SPOT	-55%
Domo Inc.	DOMO	-55%
Squarespace Inc.	SQSP	-53%
Shake Shack, Inc.	SHAK	-53%
Eventbrite Inc.	EB	-51%
Shopify Inc	SHOP	-51%
Diebold Nixdorf, Inc.	DBD	-49%
Sweetgreen Inc	SG	-48%
LYFT Inc.	LYFT	-48%
PROS Holdings, Inc.	PRO	-46%
Netflix Inc.	NFLX	-45%
Uber Technologies Inc.	UBER	-45%
Zendesk, Inc.	ZEN	-43%
Warby Parker Inc.	WRBY	-42%
Nutanix Inc	NTNX	-41%

Sources: New Constructs, LLC

Falling Knife: Warby Parker (WRBY): Down 42% from 52-Wk High & 71%+ Downside Remaining

We put Warby Parker (WRBY) in the Danger Zone in September 2021 prior to its IPO. Since the opening price on IPO date, the stock is down 35% while the S&P 500 is up 2%, and shares could fall an additional 71%. We detail Warby Parker's challenging competitive environment and weaknesses of its business model in our report here.

Valuation Implies Warby Parker Is the Largest U.S. Eyewear Retailer

When we use our reverse discounted cash flow (DCF) model to analyze the future cash flow expectations baked into Warby Parker's valuation, we provide clear, mathematical evidence that share price is too high and offers very unattractive risk/reward.

To justify its current price of $35/share, Warby Parker must:

- immediately achieve an 8.5% NOPAT margin (equal to National Vision's TTM NOPAT margin, compared to Warby Parker's -10%) and
- grow revenue by 29% compounded annually through 2028, which is nearly 5 times the projected global industry growth rate through 2028.

In this scenario, Warby Parker would generate $2.9 billion in revenue in 2028, which is nearly 6x its TTM revenue, and 113% and 146% of Vision Source and Luxottica's estimated U.S. retail sales in 2020 (most recent available data). Keep in mind, Vision Source and Luxottica were the two largest optical retailers in the United States in 2020.

We think these expectations look increasingly unlikely given Warby Parker's competitive disadvantage of being an online-first platform with very few physical retail locations. If Warby Parker's growth slows to anywhere near industry growth rates, the downside in the stock is significant.

57% Downside If Warby Parker Grows at 2x Industry Expectations

We review an additional DCF scenario to highlight the downside risk even if Warby Parker's revenue growth doubles the expected industry growth rate.

If we assume Warby Parker:

- immediately achieves a NOPAT margin of 8.5%,
- grows revenue by consensus estimates in 2021, 2022, and 2023, and
- grows revenue by 12% each year thereafter (2x industry growth rate) through 2028, then

the stock is worth just $15/share today – a 57% downside. In this scenario, Warby Parker would generate $1.5 billion in revenue in 2028, which is nearly 3x its TTM revenue and equal to estimated eyewear sales from all of Walmart retail locations in 2020.

71% Downside if Warby Parker Grows at Industry Expectations

We review a third DCF scenario to highlight the downside risk should Warby Parker's revenue growth fall in line with industry expectations.

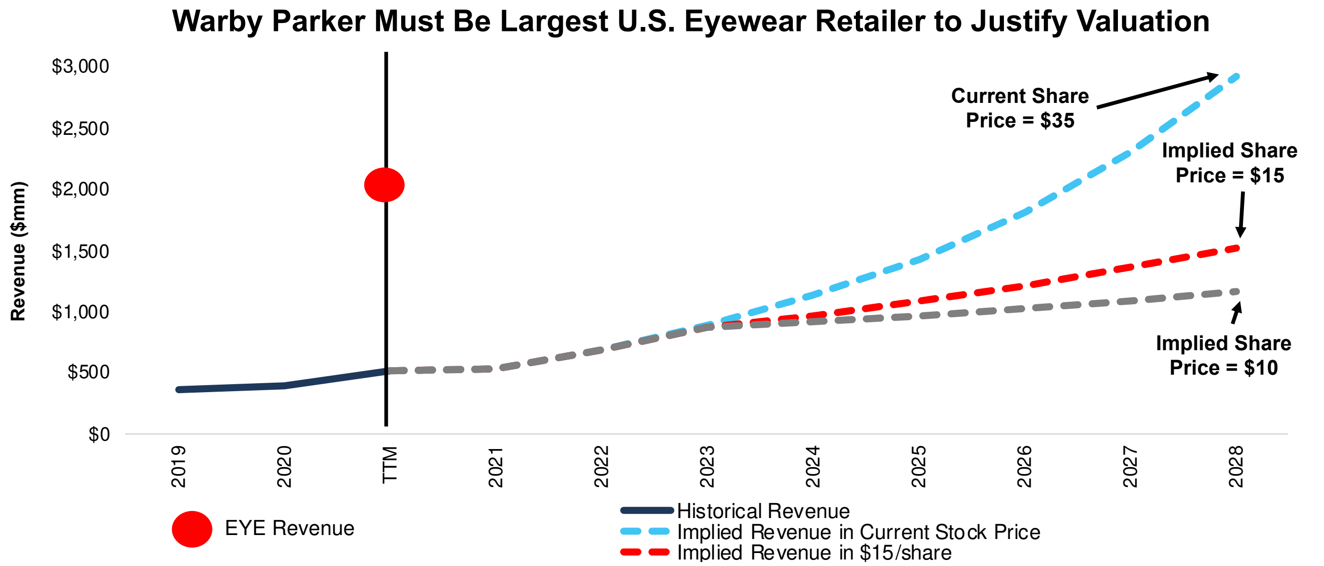
If we assume Warby Parker:

- immediately achieves a NOPAT margin of 8.5%,
- grows revenue by consensus estimates in 2021, 2022, and 2023, and
- grows revenue by 6% each year thereafter (industry growth rate) through 2028, then

the stock is worth just $10/share today million today – a 71% downside. In this scenario, Warby Parker would generate $1.1 billion in revenue in 2028, which is still more than 2x its TTM revenue.

Figure 2 compares the firm's implied future revenue in these three scenarios to its historical revenue. For reference, we include the TTM revenue of National Vision (EYE), the third largest U.S. eyewear retailer in 2020.

Figure 2: Historical Revenue vs. Implied Revenue: DCF Scenarios



Sources: New Constructs, LLC and company filings

Each of the above scenarios assume Warby Parker grows revenue, NOPAT, and FCF without increasing working capital or fixed assets. This assumption is highly unlikely but allows us to create best-case scenarios that demonstrate the level of expectations embedded in the current valuation. For reference, Warby Parker's invested capital increased $60 million (15% of revenue) YoY in 2020. If we assume Warby Parker's invested capital increases at a similar rate in DCF scenario 2 above, the downside risk is even larger.

Fundamental Research Provides Clarity in Frothy Markets

2022 has quickly shown investors that fundamentals matter and stocks don't only go up. With a better grasp on fundamentals, investors have a better sense of when to buy and sell – and – know how much risk they take when they own a stock at certain levels. Without reliable fundamental research, investors have no way of gauging whether a stock is expensive or cheap.

As shown above, disciplined, reliable fundamental research shows that even after plummeting, Uber, Affirm, Rivian, DoorDash, and Warby Parker still hold significant downside.

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life.

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Disclosure: David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, style, or theme.

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It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

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