Another Falling Knife That Could Cut Your Portfolio – Part 5

We counsel investors not to try and catch 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: Shake Shack (SHAK: $64/share). We highlight four other falling knives in other reports published today: Allbirds (BIRD: $12/share) here, Sweetgreen (SG: $31/share) here, Carvana (CVNA: $150/share) here, and Wayfair (W: $140/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 2/4/22

Company	Ticker	Off 52-Week High
Peloton Interactive Inc.	PTON	-84%
Robinhood Markets Inc.	HOOD	-82%
Koss Corp	KOSS	-80%
AMC Entertainment Holdings	AMC	-79%
Cronos Group Inc.	CRON	-77%
GameStop Corporation	GME	-71%
Pinterest Inc.	PINS	-70%
Beyond Meat Inc.	BYND	-68%
Allbirds Inc.	BIRD	-67%
Rivian Automotive	RIVN	-66%
Affirm Holdings Inc.	AFRM	-64%
LivePerson Inc.	LPSN	-63%
DoorDash, Inc.	DASH	-62%
Express Inc.	EXPR	-60%
Carvana Co.	CVNA	-60%
Wayfair, Inc.	W	-60%
Spotify Technology	SPOT	-55%
Coinbase Global Inc.	COIN	-55%
Snap Inc.	SNAP	-53%
Domo Inc.	DOMO	-52%
Sweetgreen Inc.	SG	-52%
Diebold Nixdorf, Inc.	DBD	-52%
Squarespace Inc.	SQSP	-51%
Shopify Inc.	SHOP	-50%
Shake Shack, Inc.	SHAK	-49%
Eventbrite Inc.	EB	-46%
Warby Parker Inc.	WRBY	-45%
LYFT Inc.	LYFT	-45%
PROS Holdings, Inc.	PRO	-42%
Uber Technologies Inc.	UBER	-42%
Netflix Inc.	NFLX	-41%
Zendesk, Inc.	ZEN	-41%

Sources: New Constructs, LLC

Falling Knife: Shake Shack (SHAK): Down 52% from 52-Wk High & 80%+ Downside Remaining

We put Shake Shack (SHAK) in the Danger Zone in June 2019 and reiterated our opinion on the stock in August 2021. Since the original report, the stock has outperformed the S&P 500 as a short by 57% and the stock could fall another 80%. We detail Shake Shack's lagging profitability, strong competition, and lack of meaningful differentiation in our most recent report here.

Shake Shack Priced to Surpass Bigger & More Profitable Industry Peers

Below, we use our reverse DCF model to analyze the expectations for future growth in cash flows baked into Shake Shack's current share price and show that it could fall 80%+ further.

To justify its current price of $64/share, Shake Shack must:

- improve its NOPAT margin to 11% (equal to Chipotle's TTM margin and well above Shake Shack's 0.7% TTM margin or 6% pre-pandemic 2019 margin), and
- grow revenue by 24% compounded annually through 2027 (3x projected industry growth through 2025).

In this scenario, Shake Shack would generate $2.3 billion in revenue in 2027, which is 3x its TTM revenue and over 4x its pre-pandemic 2019 revenue. At $2.3 billion, Shake Shack's revenue would more than double industry peer Red Robin Gourmet Burgers (RRGB) and be 85% of the Cheesecake Factory's (CAKE) TTM revenue.

We think it's overly optimistic to assume Shake Shack will reverse years of margin deterioration while also growing revenue three times as fast as the overall industry. In a more realistic scenario, detailed below, the stock has large downside risk.

63%+ Downside if Consensus is Right

We review an additional DCF scenario to highlight the downside risk if Shake Shack's revenue grows more in-line with consensus estimates and the firm can re-achieve its pre-pandemic margins.

If we assume Shake Shack's:

- NOPAT margin improves to 6% (equal to pre-pandemic 2019 level),
- revenue grows at consensus rates in 2021 2022, and 2023, and
- revenue grows 16% a year in 2024-2027 (double industry growth rate through 2025), then

the stock is worth $24/share today – a 63% downside to the current price. This scenario still implies Shake Shack's NOPAT quadruples from 2019 levels (highest in company history).

If Shake Shack fails to improve margins (likely given that labor costs are expected to weigh on profitability) or grow revenue at consensus rates, the downside risk in the stock is even higher.

80%+ Downside If Revenue Growth Slows to Industry Expectations

We review a third DCF scenario to highlight the downside risk if Shake Shack's revenue growth slows to equal the overall fast casual industry growth rate beyond 2023.

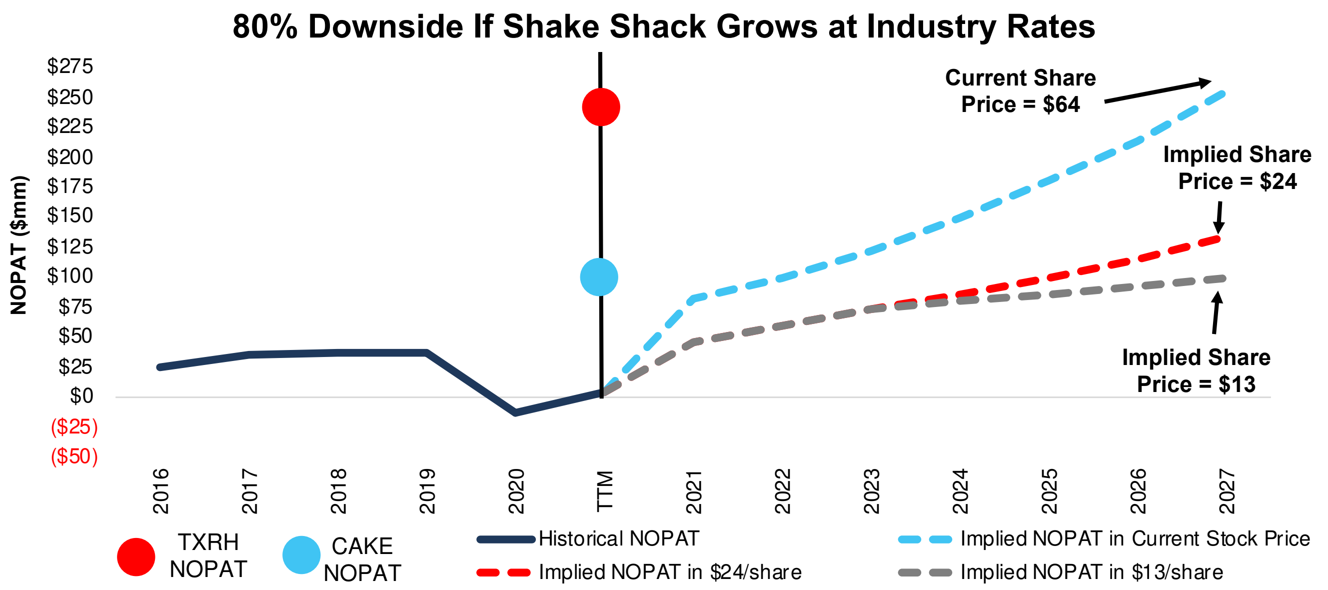
If we assume Shake Shack's:

- NOPAT margin improves to 6%,
- revenue grows at consensus rates in 2021, 2022, and 2023, and
- revenue grows 8% a year from 2024-2027 (equal to projected industry CAGR through 2025), then

the stock is worth $13/share today – an 80% downside to the current price.

Figure 2 compares Shake Shack's implied future NOPAT in these three scenarios to its historical NOPAT. For reference, we include the TTM NOPAT of peers Texas Roadhouse (TXRH) and Cheesecake Factory.

Figure 2: Shake Shack's Historical and Implied NOPAT: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings.

Each of the above scenarios assumes Shake Shack's YoY change in invested capital is 9% of revenue in each year of our DCF model, given the firm's expansion plans. Such an estimate could prove conservative but allows us to create best-case scenarios that demonstrate how high expectations embedded in the current valuation are For context, Shake Shack's invested capital averaged 22% of revenue from 2016-TTM and invested capital has grown 21% compounded annually since 2016.

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 what and 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 reliable way of knowing whether a stock is expensive or cheap.

As shown above, disciplined, reliable fundamental research shows that even after plummeting, Allbirds, Sweetgreen, Carvana, Wayfair, and Shake Shack still hold significant downside.

This article originally published on February 7, 2022.

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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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.

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