January 2016

This Firm Is 'Daylighting' Hidden Value From A Multi-Billion Dollar Sector

As a business strategy, selling to your softball teammates really isn't the best way to optimize profits.

And yet, that's exactly how things used to get done where I grew up.

In the prairie climes of Alberta, Canada, there's actually a lot of start-up companies that get launched. They're mostly from the oil patch, which is a multi-billion dollar business in that part of the world.

Of course, many of these are big-scale ventures -- drilling companies with large fleets of rigs, oil exploration companies that control thousands of acres, as well as law firms, accountancies, and human resources conglomerates that support them.

But there's also room in this landscape for smaller players.

There are the guys who sell special sand to drilling companies for use in the "fracking" procedures that have become increasingly common over the last decade.

There are people who sell specialty chemicals to exploration firms to aid in the development of effective drilling fluids.

There's even an entire sector of oil field services known as "hot shots" -- which consists of drivers who are ready, at a moment's notice night or day, to drive hundreds or even thousands of miles non-stop to deliver a single spare part needed on a rig that has broken down in the wilderness.

Over the years, I've had many friends who got into these various facets -- starting up their own companies to get their piece of the vast investments that flowed into Alberta during the heyday of petro-industry that recently prevailed there.

And the way they did business was peculiar.

Many of these oil field start-ups were little more than one or two people, a truck and some basic equipment. Really that's all you needed to get started.
That meant overheads for such operations were relatively low. And with only a couple of mouths to feed at the company, a business was generally deemed "successful" if it brought in a few hundred thousand dollars in yearly profits -- enough to give the founding partners a good life for themselves and their families.

Now, it's really not that hard to scrape together a few hundred thousand in business in a raging bull market like Alberta was seeing at the time.

In fact, most of the people I know were able to do their "business development" over a couple of beers at the end of an oil industry softball game. They simply asked their buddies if they could supply the next load of sand, frack fluids, or the next hot shot.

That was enough to give them the lifestyle they wanted. And so they didn't push much beyond such basic marketing, even when it was clear that a little effort would have opened up a much larger potential base of clients.

And that became a major opportunity for one enterprising firm -- which turned these "mom and pop" businesses into a billion-dollar empire.

A Little Marketing Can Go A Long Way In Profits And Valuation

A few years ago, I was attending an energy conference. And I met a company that had not only recognized the Alberta mom and pop business mentality -- but had developed a strategy to reap big profits from it: Canadian Energy Services (OTC: CESDF).

The firm's management told me how they spent hundreds of hours looking over various small businesses across the province -- mostly in the areas of drilling chemicals, transport and logistics and environmental services.

Through this review, they found a lot of great business potential: firms that had unique assets, proprietary formulas or unparalleled expertise in niche oil field markets.

The only thing missing was a platform for real growth. Most of these high-potential companies were content to tap their at-hand network for contracts, rather than aggressively seek new customers.

So, Canadian Energy Services (CES) did it for them.

The CES management team realized that for many of these mom and pop organizations, the only thing better than working for a few hundreds thousand dollars yearly was getting a buyout and not having to work anymore. And they realized this didn't take a lot of cash -- a lot of Albertans were happy to take a cool million or two and retire to their lake homes or mountain cottages.

So CES began striking deals, buying prime businesses at low multiples to cash flow. It was much like Warren Buffett did at the beginning of his investment career, when he bought out homegrown firms like Nebraska Furniture Mart.

The best part was that CES already had scale in marketing, having offices throughout western Canada and into the United States.
Thus, CES could take a great product it bought cheap and immediately ramp up revenues and profits by marketing it beyond the softball diamond to oil drillers across the continent. The expense involved was minor, and the results in profits was dramatic.

The slide below from a recent CES presentation shows the story. At the bottom is a roll call of the small firms the company acquired over the years -- and the colored lines show rising revenues won by each new business segment after it was brought under the CES banner.

Source: Canadian Energy Services

The real winners from this astute strategy were the CES shareholders. As the chart below shows, rising profits from all the company's acquisitions sent the share price on a moon-shot trip from below C$0.50 in 2009 to as high as C$11.68 in early 2014 -- for an incredible 2,300% gain.
The stock has come off hard since the collapse in the oil price in mid-2014. But that doesn't diminish the brilliance of the CES business approach -- namely, "daylighting" value from small-scale business through the application of a systematic and wide-reaching business network.

The ride in the oil patch may be over for the moment. But I believe a similar pattern is now setting up in another industry. And it's one that could have even greater potential for unlocking profits through a wave of acquisitions that has started the last few years.

"Mom And Pops" Are Hot Acquisitions Right Now In This Up-And-Coming Sector

I always remembered the unique strategy employed by Canadian Energy Services in acquiring mom and pop businesses and then using a widespread network to extract multiples of value.

And lately, I've been noticing a similar pattern unfolding -- in a different industry.

Information.

You see, years ago I used to follow data on the mining sector provided by a little-known boutique research firm called Metals Economics Group (MEG).

This group was a relatively small outfit run out of Halifax, Nova Scotia. My guess would be the company consisted of no more than a few people -- who diligently gathered information on the global minerals business and compiled it into some of the most comprehensive data sets and reports available anywhere in the industry.

Like the mom and pop oil field operations I discussed above, it didn't appear that MEG put a lot of effort into marketing. In fact, many professionals I knew in the global mining business had never heard of the firm.

I would imagine the company functioned in much the same way as the "softball marketing" that happens in Alberta -- having a close network of people who paid for their research. It was likely enough to make a decent living for the small group running the firm.

But a few of the people who did notice MEG saw big things in the company.

That included SNL Financial, a larger provider of boutique research in natural resources, real estate and other industries. And so in 2012, SNL took a page from the Canadian Energy Services handbook, and bought out MEG.

Now, there are no metrics available on what SNL paid as part of this deal. But I can almost guarantee it was a low multiple to the cash that MEG was bringing in.

With the deal in hand, SNL began marketing the newly acquired mining research across its wider network. And the results of that exercise, in turn, got the company noticed by a bigger fish -- McGraw Hill Financial (NYSE: MHFI), a leading publisher of financial information, which bought out SNL for $2.23 billion earlier this year.
McGraw Hill then integrated SNL into its S&P Capital IQ division -- a sister outfit to the publisher of the much-followed S&P financial indices. That completed a chain of deals that had transformed a small, boutique research firm into part of a global empire of data solutions.

And that’s not the only recent example of a mom and pop shop going global.

Another service I used to use often was Bentek Energy -- a Colorado-based provider of data and information on oil and gas pipelines across the U.S.

In 2010, Bentek was bought by Platts -- one of the biggest names in data for the natural resources sector. Platts, in turn, is owned by McGraw Hill.

Notice a pattern setting up here?

To me, deals like this are confirming a trend toward consolidation in the information space -- with big players seeking to unlock value from smaller shops through acquisition into a bigger, wider-reaching corporate platform.

If the case of Canadian Energy Services -- and its 2,300% gain in just five years -- is any indication, these acquisitions could signal the start of a massive profit opportunity in the information space.

And this month, one of my colleagues at StreetAuthority came up with the perfect stock to invest in this trend.

This Month’s Top Stock

**Morningstar (Nasdaq: MORN)**

I’ve been thinking about the trend toward acquisitions and value-adding in the information space for a few months now -- after having lunch with a friend who works at the above-mentioned SNL Financial and hearing him describe the rapid-fire chain of buyouts the company has gone through recently.

And when I heard this month from my colleague Amy Calistri about a stock she was researching for her *Stock Of The Month* advisory, everything suddenly clicked.

Amy was looking at Morningstar (Nasdaq: MORN). It’s a company that may not be commonly talked about on “the street” -- but it’s known to every person engaged in the investment management business across America and beyond.

Morningstar provides some of the best information and data in this space.

As Amy’s research shows, Morningstar today operates in 27 countries, providing real-time market data for over 17 million stocks, indexes, futures, options and commodities. The company also provides in-depth data and analysis on more than half a million investment offerings, including stocks and mutual funds.

Much of this data is targeted to investment managers, who use Morningstar to analyze
and benchmark all sorts of products as they consider where to allocate the dollars placed under their watch. As of last year, Morningstar reported that its users managed $81 billion in funds.

Given that amount, it's easy to see the value proposition in a firm like this. Morningstar's data is available for just a few hundred dollars -- meaning that most investment managers don't even blink at the thought of signing up. It's almost a must-have item for this industry.

That wide-reaching network of clients gives Morningstar a strong platform for growth. And they've been making good use of it -- buying out smaller firms in the investment data business and "daylighting" value from them through wider marketing.

Between 2006 and 2010, Morningstar bought out 24 smaller firms. And the company continues to pursue consolidation -- last year completing acquisitions of data aggregator ByAllAccounts as well as HelloWallet, a company delivering financial advice to employees of large companies.

This is exactly the sort of "buy and grow" strategy that's been going gangbusters in other parts of the data and information industry. And I believe it could make Morningstar a target for a buyout in this increasingly in-demand space -- especially in light of the company's recent financial performance.

**Revenues And Profits Are Rising Steadily As The Firm's Reach Expands**

One of the big reasons I agree so strongly with Amy's recommendation of Morningstar is the extreme growth that the global investment industry is seeing.

Just look at the chart below, showing amounts invested in just one segment of the investment world -- exchange-traded funds (ETFs) and hedge funds -- over the last two decades. Investment here has grown nearly 3,000% since 1993, to almost $6 trillion.

![Chart showing growth in ETF and hedge fund assets](chart.png)

*Source: ETFGI*

That growth means there's a lot of work for investment managers. And that's great news for a firm like Morningstar, which sells its products to exactly this audience.
For 2014, Morningstar reported revenues of $760 million -- up 9% from 2013, and an increase of 37% from 2010.

Morningstar's net income has also been rising steadily the last five years, with 2013 earnings coming in 43% higher than 2010 levels, at $123.5 million. Earnings in 2014 would have been up substantially from 2013, had it not been for a one-time charge of $61 million related to the settlement of a lawsuit.

Revenues and net income look to be on pace to set an all-time high in 2015 -- continuing the trend.

Another thing I like about Morningstar is that it derives the majority of its revenues in the United States, with nearly 75% of the firm's business being done domestically.

That largely insulates the company from changes in earnings caused by foreign currency fluctuations against the dollar.

That said, the international investment community offers a sizeable growth opportunity for Morningstar, with the company starting to make inroads into markets like Asia -- where the investment industry is rising in spots such as China.

The great thing is that it should be relatively easy for an information provider like Morningstar to enter such markets. In fact, I wouldn't be surprised to see the company making moves to acquire local investment information companies in some overseas locales, to further this end.

I also wouldn't be surprised to see the opposite situation unfold -- a larger company making a bid to take over Morningstar. Much of this would be dependent on the wishes of Morningstar's founder, chairman and CEO Joe Mansueto -- who maintains a majority shareholding in the company, and thus would have to agree to any buyout put on the table.

Above-mentioned McGraw Hill would be the most obvious candidate to offer to acquire Morningstar. With that firm's $26 billion valuation being several times larger than Morningstar's current market capitalization of $3.6 billion.

Any takeover would likely reward existing shareholders with a considerable premium in recognition of Morningstar's demonstrated track record of growth. And even if a buyout doesn't materialize, I believe this stock is going to continue to perform very well over the coming months and years as a standalone entity.

**Action to Take:** I'll be adding 40 shares of Morningstar to my portfolio. My target price for the stock is set at $102.50, where the company would trade in line with the average price-to-earnings ratio for its sector. My buy under price is $86.88, which is the year-high trading value for the company, set in August.

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**A Huge Gift From StreetAuthority’s Founder**

StreetAuthority founder Lou Betancourt just authorized the biggest giveaway in our 15-year
The Top 10 Stocks portfolio is designed to profit from my favorite ideas from all of StreetAuthority's premium investment advisories.

**Irrereplaceable Assets**
Because they own rare assets that would be difficult -- if not impossible -- for competitors to replicate, these companies are some of the world's greatest businesses. Read more

**Wide Moat Businesses**
Wide moats keep competition to a minimum, and make these firms excellent long-term investment candidates. Read more

**The Most Shareholder-Friendly Companies on Earth**
These companies richly reward shareholders with large buybacks or big dividends. Read more
American Innovators
Thanks to ingenuity and research, these homegrown firms rank head and shoulders above global competition. Read more

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Portfolio Performance

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"Total Returns" include capital gains, and reinvested dividends since each position was added.
"Purchase Price" doesn't include shares bought via reinvestment, but does include brokerage commissions. See a list of all closed trades, here.

Updates

Another big dividend was announced by CME Group (Nasdaq: CME) this month when management revealed that its annual "variable" dividend will pay shareholders a substantial $2.90 per share.

This is CME's regular year-end distribution of excess funds, and comes in addition to the company's regular dividend of $0.50 per quarter.

All told, that means CME will have paid out $4.90 per share in dividends this year -- equating to a 5.3% dividend yield at the stock's current share price.

That's well over double the 2.2% currently being paid out by the S&P 500 -- showing that this fast-growing company continues to reward shareholders in an outsized way.
Another stock that appears to be setting up for enhanced profits is **L Brands (NYSE: LB)**, with the company announcing that revenues for the 43 weeks ended November 28 were up 5% as compared to same period of 2014 -- hitting $8.928 billion.

Importantly, it looks like the trend toward increased sales is accelerating -- with L Brands saying that sales for the four weeks to November 28 actually posted an 8% rise, to $1.169 billion.

All of this information suggests this is a firm that's improving its financial performance quickly.

**Action to Take:** I love rising profits -- and even more when companies return them to shareholders. I'm maintaining my portfolio holdings of outperformers CME Group and L Brands, as well as my target prices of $126 and $141, respectively.

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**Q&A**

Do you have a question or comment about something you've seen in *Top 10 Stocks*? Do you want my opinion on a particular company? I always try to personally answer as many reader questions as I can. I will share those questions -- and answers -- that I believe are of the broadest interest to the *Top 10 Stocks* community. Please send your questions to me at Top10Stocks@StreetAuthority.com.

**Q:** Everything I research says PVH Corp. is a bad buy. Barchart.com and several others say no. Is it time to sell?  

--- James M.

**A:**

I've been getting a lot of variations on this question regarding **PVH Corp. (NYSE: PVH)**.

And to answer, I'd like to go back to the 1950s.

That was when a professor at Swarthmore College in Pennsylvania, Solomon Asch, conducted a then-groundbreaking psychological test: the Asch conformity experiment.

The Asch conformity experiment was simple. The professor asked groups of students to look at a card with three lines, each of different lengths -- and then another card with a single line.

The test subjects were then asked which of the three lines matched the length of the single line. Easy, right?

But there was a catch. All but one of the "test subjects" in each group were actors planted by Asch whom were told to answer in a way that was blatantly wrong -- that is, choose a line from the group of three that was obviously much longer or shorter than the single line on the other card.

The results were astonishing. After watching the actors give an obviously wrong answer, a full 76.4% of the actual test subjects also changed their answers to agree with the wrong choice. The power of peer pressure -- seeing...
other humans giving a dissenting opinion -- was simply too strong to resist, even in face of all logic and observation.

And that's exactly what investors go through when we sift through the mountains of financial research out there today.

As humans, we're programmed to look at what the people around us do, and then do the same.

But in investing, the "do just as others do" strategy doesn't work. Simply put, there's such a multitude of financial advice out there today -- on the Internet, television and beyond -- that if we look for a negative opinion on a stock, we will find someone talking it down.

And that will shock our brains into shouting "sell."

But we can just as easily find the exact opposite opinions. For example, a quick look at my Morningstar data screen tells me that 80% of Wall Street analysts covering PVH rate it a "buy", while the other 20% rate it "outperform." There are no "hold" or "sell" recommendations from these professionals.

I wouldn't take this as gospel on the future of the stock -- Wall Street firms have a wide range of reasons for their recommendations, some useful and some not. But it illustrates the point that there will always be positive as well as negative voices out there, for any stock we might look at.

The bottom line is, we need to do our own thinking. And when I look at the cold, hard numbers behind PVH, I still see a great story unfolding.

The company has reported free cash flow of $602 million for the trailing 12-month period -- up 13% from the $533 million it enjoyed during the full-year 2014. That's a sign of an improving business, no matter what the pundits might say. I'm sticking with this one.

**Action to Take:** Forget what the herd says -- based on the financial results, I'm maintaining my portfolio position in PVH Corp, and my target price of $212 for the stock.

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**Recommended Reading**

- Here's an [Ernst & Young presentation](#) on challenges and opportunities associated with acquiring "mom and pop" businesses.

- And here's a [Psychology Today overview](#) on the human need to conform to the views of others, noting that "throughout history, bad information gleaned from ill informed, deluded, or malevolent others has been responsible for many a military, financial and personal calamity."

**Dave's "Buy First" List**
When new readers sign up, their first question is often: What should I buy first?

In the table below I’ve listed my top "Buy First" pick based on today's environment and current share prices.

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<th>Security (Symbol)</th>
<th>Price</th>
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<td>PVH Corp (NYSE: PVH)</td>
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I'm continuing to recommend PVH Corp (NYSE: PVH) as a buy first this month -- with this excellent business appearing to have stabilized its share price around the $72 level, after a 38% decline since mid-September.

As discussed above, the latest financial results for PVH continue to show the company improving its business performance. And today, we can buy the firm at a P/E ratio of just 12.4x -- as compared to an average of 22.5x for its industry, and a 5-year average of 41.9x for the stock.

Consider putting 5% of your portfolio here.

Thank you for reading today's issue of Top 10 Stocks.

Good investing,

Dave Forest
Chief Investment Strategist, Top 10 Stocks

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