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MORNINGSIDE HILL
CAPITAL MANAGEMENT

US CORPORATE EARNINGS: NOT ONLY FALLING BUT RAPIDLY DETERIORATING IN QUALITY

The difference between adjusted and GAAP numbers is becoming alarming

- In the past few years more and more companies are reporting adjusted numbers, in addition to the officially required GAAP ones. Wall Street and the media are predominantly quoting the adjusted figures, which are **currently 30% higher than those reported according to the Generally Accepted Accounting Principles (GAAP)**. We believe that this significant difference is largely unjustified and we explain why below. The result is a recent acceleration in earnings quality deterioration, which also makes historical comparisons increasingly more difficult, while the market looks misleadingly cheaper than it actually is.

- Most sells-side and media-quoted numbers are sourced from Thomson Reuters and Factset. The difference in the EPS reported by the agencies and the GAAP EPS has been staggering:[1]

S&P 500 EPS According to Different Sources by Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 *
Thomson Reuters EPS	$88.18	$85.12	$65.47	$60.80	$85.28	$97.82	$103.80	$109.68	$118.78	$117.28
y.o.y. % change		(3.5%)	(23.1%)	(7.1%)	40.3%	14.7%	6.1%	5.7%	8.3%	(1.3%)
Factset EPS	$83.20	$81.79	$71.43	$59.34	$83.10	$94.85	$102.47	$108.47	$116.77	$118.36
y.o.y. % change		(1.7%)	(12.7%)	(16.9%)	40.0%	14.1%	8.0%	5.9%	7.7%	1.4%
GAAP EPS	$81.51	$66.18	$14.88	$50.97	$77.35	$86.95	$86.51	$100.20	$102.31	$90.57
y.o.y. % change		(18.8%)	(77.5%)	242.5%	51.8%	12.4%	(0.5%)	15.8%	2.1%	(11.5%)
Difference between THOMSON REUTERS and GAAP EPS	**8.2%**	**28.6%**	**340.0%**	**19.3%**	**10.3%**	**12.5%**	**20.0%**	**9.5%**	**16.1%**	**29.5%**
Difference between FACTSET and GAAP EPS	**2.1%**	**23.6%**	**380.0%**	**16.4%**	**7.4%**	**9.1%**	**18.4%**	**8.3%**	**14.1%**	**30.7%**

* Q4 2015 is estimated with 76% of the index companies having already reported at the time of writing

- One could notice that when the business environment becomes difficult for US corporations, they report increasingly higher adjusted numbers relative to GAAP as in, for example, 2007-8.

- While mainstream media and the sell-side, quoting Thomson Reuters and Factset, present 2015 as a "flat EPS growth year," GAAP EPS has actually declined by 11.5%.

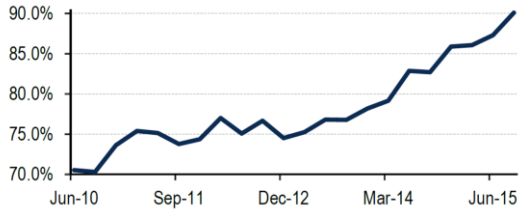
- From both a business and an accounting perspective, there is no other reason for the falling GAAP number save the deteriorating macro and business environment. However, as we explain in this paper, there are plenty of reasons that explain why the adjusted numbers are increasingly misrepresenting the true earnings power of US companies.

[1] Thomson Reuters: https://www.google.com.ng/webhp?sourceid=chrome-instant&ion=1&espv=2&ie=UTF-8#q=thomson+reuters+THIS+WEEK+IN+EARNINGS
Factset numbers from: http://www.factset.com/websitefiles/PDFs/earningsinsight/earningsinsight_2.12.16
GAAP numbers acquired from S&P Indices official website: us.spindices.com/indices/equity/sp-500

The proliferation of adjusted numbers after the crisis

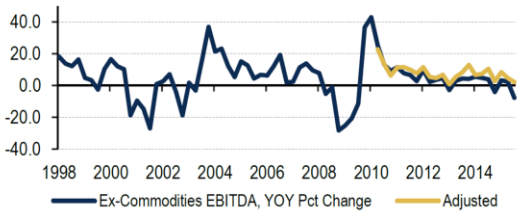
- The challenging earnings environment makes it attractive for more and more companies to report adjusted numbers. The first graph from BofA Merrill Lynch demonstrates the increasing number of companies resorting to adjusted numbers, with the total number being 90% of all companies today compared to 70% just 5 years ago. The second graph shows the growth in ex-commodities (read ex-oil and gas) EBITDA, a proxy for cash flows. This number is at its lowest value since 2000, while the adjusted number remains flattish.[2]

Chart 1: Percentage of companies reporting adjusted earnings has risen sharply



Source: BofA Merrill Lynch Global Research

Chart 2: Non-recessionary unadjusted EBITDA growth is the worst since 2000



Source: BofA Merrill Lynch Global Research

- According to another study, 334 companies in the S&P 500 reported non-GAAP earnings last year with a total value of adjustments of $132bn, up from 232 such companies in 2009 with only $62bn in total adjustments.[3]

- In the aftermath of the Dotcom bubble crash, companies were increasingly utilizing new non-standard measures in order to embellish their dismal earnings. In 2003 the SEC legitimized the presentation of non-GAAP earnings by setting ground rules for their presentation and providing a safe harbor for companies under the new Regulation D. One couldn't help but wonder if after the Dotcom bubble burst, the SEC might have fallen under heavy Wall Street lobbying to provide a legal framework for presenting non-traditional earnings numbers, in order to lure investors back in the markets.

- The reason behind permitting companies to report adjusted figures is that it can make sense in the case of omitting one-off, non-recurring or non-cash expenses – specifically when they make comparisons from one period to another challenging. Companies, of course, have found ways to instrumentalize this leeway to the point where they are taking outright advantage of the regulation, in order to present better-looking numbers. The regulation, which was intended to focus on exceptions, gradually became the norm. As more and more companies adopted the new norm, others were forced to follow suit so as to continue to appear competitive.

- Currently, companies have unprecedented freedom to choose which costs to remove from the earnings calculation as long as they provide both the GAAP number and the reconciliation.

- In some cases the difference between adjusted and GAAP numbers is significant. For 2014 Valeant Pharmaceuticals earned $0.9bn under GAAP while reporting a "cash EPS" of $2.82bn. For the first 9 months of 2015 Zoe's reported adjusted profit of $13.2m and a GAAP loss of $8.4m. For the first 9 months of 2015, Adeptus Health stripped out $2.4m in management bonuses, $6.1m in preopening costs for new facilities and $0.1m in management recruiting expense to get from a $15.8m loss to an $18m profit under "Adjusted EBITDA."[4,5,6]

- 40 companies that IPO'ed in 2014 are reporting negative earnings under GAAP and positive profits under adjusted measures.[4] 59% of the companies that IPO'ed since 2012 have used adjusted metrics, compared with 48% in 2011, a 20% increase.[5]

- In their reports, companies use different names for non-GAAP earnings – operating, adjusted, cash or pro-forma.

[2] http://www.bloomberg.com/news/articles/2016-01-12/bank-of-america-limited-earnings-power-is-prompting-more-companies-to-put-lipstick-on-a-pig-each-quarter
[3] http://accountingobserver.com/product/volume-24-no-10/
[4] http://blogs.wsj.com/moneybeat/2015/01/08/what-companies-strip-out-of-non-gaap-earnings-fines-exec-bonuses-severance-rebranding-costs/
[5] http://www.wsj.com/articles/tailored-accounting-at-ipos-raises-flags-1420677431?tesla=y&mg=reno64-wsj
[6] http://www.nytimes.com/2015/11/01/business/valeant-shows-the-perils-of-fantasy-numbers.html

- What are the typical adjustments to earnings? Adjusted numbers can exclude a whole array of costs. We have estimated that about 70-80% of the adjustments in dollar amounts do not serve any purpose other than making company earnings appear better than they are:

Adjustments to Earnings	
That are increasingly being misused by companies:	**That make sense to adjust for:**
Management bonuses	Amortization (depending)
Stock-based compensation	Impairments (depending)
Regulatory expenses	Pension adjustments
Rebranding costs	Debt extinguishment / refinancing
Litigation charges	Deffered tax asset valuation
Restructuring charges	profits and losses
M&A fees and expenses	…
Management recruitment costs	truly 1-offs, as in 1 per decade costs
Board of Director's fees	
Currency adjustments	
Amortization (depending)	
Impairments (depending)	
70%-80% of current adjustments	**20%-30% of current adjustments**

- Companies increasingly label large **management bonuses and recruitment costs** as one-off expenses – in reality these are true costs to the business. **Stock-based comp** is being excluded as a non-cash item – if a gold miner pays its employees in gold should that be accounted for as cost or not? **Regulatory expenses** are labeled one-offs in a world where they recur every year in a world of ever-growing regulation. The same goes for **litigation charges** in today's litigious society. **Restructuring charges** are also a true cost to the business even if they don't appear every year – a company should spread them over a period rather them exclude them as if they don't exist. Excluding **M&A fees** is another aggressive and dissembling practice – those fees are a real cost of acquiring assets especially for companies that grow mainly through M&A, a rapidly growing group in this cycle.

- Excluding the **effect of currencies** is a favorite adjustment of ours and is currently one of growing magnitude. The fact that last year the USD was trading for X euros doesn't mean that this is the "right" exchange rate and that management should present all subsequent sales and earnings numbers as if this rate is persistent. Currencies can be volatile while certain rates can remain the same for decades. Companies should report the real numbers according to the real exchange rates rather than play fantasy earnings.

- Companies remove 100% of **amortization and impairments** of intangibles as non-cash expenses, while in many cases they should not. For example one company can rent software-as-a-service which goes in as an expense. Another company can buy the software, which has a limited life, and exclude its amortization from its expenses treating it as a non-cash item. When in a few years the software is outdated and fully amortized, this company's earnings would have been overstated.

- A growing concern with these adjustments, as we will see later with Level 3 Communications Corp., is that **companies tend to adjust earnings in only one direction – if the adjustment increases earnings**. For example, if the exchange rate has been favorable for the company we would rarely see a negative adjustment. Or if the company has a profit from a deferred tax asset valuation adjustment it will likely not be removed. It is simply being omitted. However, if the company sees a loss from any of the above it will likely be treated as a non-recurring, non-cash item and thus be adjusted for.

- Adjusted numbers have been quite convenient for both Wall Street and listed companies – it's much easier to sell a company at 18x adjusted earnings than at 30x GAAP earnings.

- Although one would expect that investors stick to the facts and ignore adjusted numbers academic research appears to show that adjusted numbers are in fact driving stock prices.[6]

[6] http://www.nytimes.com/2015/11/01/business/valeant-shows-the-perils-of-fantasy-numbers.html

A look at the US earnings numbers – both adjusted and GAAP

- We look at the S&P 500 index which accounts for 80% of the market cap in the US.
- Exacerbating the above-described adjusted versus GAAP mess, most news and information agencies (i.e. Thomson Reuters, Factset and Capital IQ) are reporting numbers computed from a mix of adjusted and GAAP earnings – cherry-picking whatever makes the total number appear larger.

S&P 500 EPS According to Different Sources by Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 *
Thomson Reuters EPS	$88.18	$85.12	$65.47	$60.80	$85.28	$97.82	$103.80	$109.68	$118.78	$117.28
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Factset EPS	$83.20	$81.79	$71.43	$59.34	$83.10	$94.85	$102.47	$108.47	$116.77	$118.36
y.o.y. % change		(1.7%)	(12.7%)	(16.9%)	40.0%	14.1%	8.0%	5.9%	7.7%	1.4%
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Difference between THOMSON REUTERS and GAAP EPS	**8.2%**	**28.6%**	**340.0%**	**19.3%**	**10.3%**	**12.5%**	**20.0%**	**9.5%**	**16.1%**	**29.5%**
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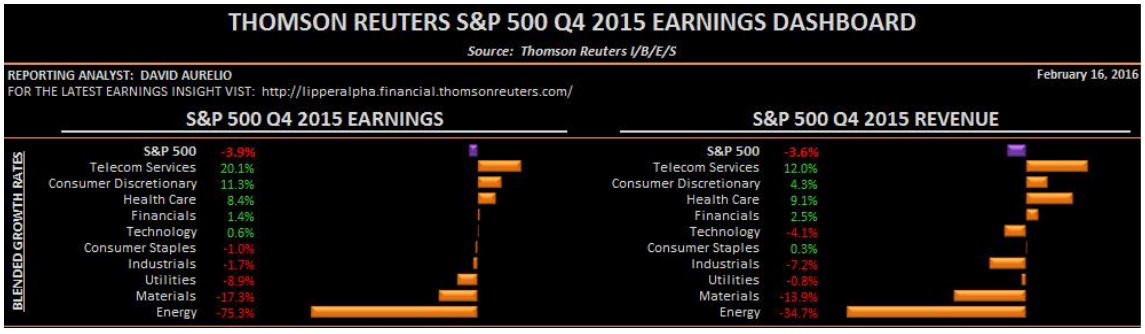
- As seen above, profits aren't growing – companies are simply massaging the numbers more. One look at the table shows this is exactly what happened before the last crisis.
- Since GAAP earnings were flat in 2014 and fell by 11.5% in 2015 let's zoom in to see when the trend turned:

S&P 500 EPS According to Different Sources by Quarter	2013		2014				2015*			
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4*
Thomson Reuters EPS	$27.63	$28.62	$28.18	$30.07	$30.04	$30.54	$28.60	$30.09	$29.99	$29.39
y.o.y. % change			5.4%	9.7%	8.7%	6.7%	1.5%	0.1%	(0.2%)	(3.8%)
q.o.q. % change	0.8%	3.6%	(1.5%)	6.7%	(0.1%)	1.7%	(6.4%)	5.2%	(0.3%)	(2.0%)
Factset EPS	$26.96	$28.51	$27.85	$29.67	$29.97	$30.33	$28.57	$29.92	$30.19	$29.68
y.o.y. % change				10.3%	11.2%	6.4%	2.6%	0.8%	0.7%	(2.1%)
q.o.q. % change	0.2%	5.7%	(2.3%)	6.5%	1.0%	1.2%	(5.8%)	4.7%	0.9%	(1.7%)
GAAP EPS	$24.63	$26.48	$24.87	$27.14	$27.47	$22.83	$21.81	$22.80	$23.22	$22.74
y.o.y. % change			2.7%	9.1%	11.5%	(13.8%)	(12.3%)	(16.0%)	(15.5%)	(0.4%)
q.o.q. % change	(1.0%)	7.5%	(6.1%)	9.1%	1.2%	(16.9%)	(4.5%)	4.5%	1.8%	(2.1%)
Difference between THOMSON REUTERS and GAAP EPS	**12.2%**	**8.1%**	**13.3%**	**10.8%**	**9.4%**	**33.8%**	**31.1%**	**32.0%**	**29.2%**	**29.2%**
Difference between FACTSET and GAAP EPS	**9.5%**	**7.7%**	**12.0%**	**9.3%**	**9.1%**	**32.9%**	**31.0%**	**31.2%**	**30.0%**	**30.5%**

- Earnings started to deteriorate back in Q4 of 2014 and we are now more than a year into the earnings recession. According to the media the earnings recession started in Q2 of 2015 while in reality it started 3 quarters earlier.
- Revenues have had 4 consecutive quarters of negative growth. Revenues are harder to manipulate than earnings.
- Now let's zoom into Thomson Reuters' "blended EPS" for Q4 of 2015. The picture looks dire:[7]



- People are blaming the lower earnings on energy but it is obviously not just energy.

[7] http://lipperalpha.financial.thomsonreuters.com/2016/02/sp-500-earnings-dashboard-feb-16th-2016/

- Energy, materials, utilities, industrials and consumer staples all have negative growth. The more troubling part is that revenues are down considerably as well. Even technology revenues are down and technology is one of the pillars of the US economy.

- Some analysts say "if we look at earnings without energy everything seems all right." But we can't selectively remove parts of the index that we don't like. It's akin to saying back in 2008 that everything apart from housing finance looks all right. Even then, as visible in the report, it's not only energy but 5 other sectors too.

- Let's look into why the telecoms sector is reporting such strong revenue growth. Factset explains:[8]

> *"The Telecom Services sector is reporting the highest revenue growth of all ten sectors* ***at 12.0%****. At the company level, AT&T is the largest contributor to revenue growth for the sector. The company reported actual sales of $42.1 billion for Q4 2015 (which reflects the combination of AT&T and DIRECTV), compared to year-ago sales (which reflects standalone AT&T) of $34.4 billion.* ***If AT&T is excluded, the blended growth rate for the sector would fall to 3.3%****."*

- Then let's look into the telecoms sector's strong EPS growth. Factset explains again:[8]

> *"Of the five companies in the sector, Level 3 Communications is the largest contributor to earnings growth. The company reported actual* ***EPS of $9.24*** *for Q4 2015 (which includes a* ***non-cash benefit of $3.3 billion*** *to income tax expense related to the release of the company's valuation allowance against U.S federal and state deferred tax assets), compared to year-ago* ***EPS of $0.21****."*

- Let's dwell on this for a few moments. When most companies are becoming remarkably creative in finding items they can call one-off or non-cash in order to exclude from their earnings calculation, Level 3 Communications **is leaving** a positive one-off, non-cash item which is **artificially tripling the growth of the entire telecoms sector**. Instead of adjusting its net income down, since this valuation allowance benefit is **the epitome of a one-off non-cash item** that simply distorts the picture and makes comparisons difficult, the management leaves it there because it is positive. We are startled by these selective adjustments.

- Now we understand how the best performing sector, the telecoms, got both its impressive revenue and EPS growth rates. The revenue growth is explained by a large M&A deal that added a huge new company's revenues to the total for the industry. The earnings growth is due to an accounting operation that should have been adjusted for by removing the enormous one-off, non-cash positive number instead of leaving it in.

- We find it amusing that economists and journalists talk about earnings ex-energy (to show that earnings ex-energy look better) but they do not discuss earnings ex-telecoms. **Energy is down for a good reason since the slump in EPS and revenue in this sector is real. On the other hand, much of the outsized revenue and EPS growth of the telecoms sector is not real.**

- Reasons cited for the S&P earnings slump include the strong dollar and weak international demand. More than 40% of S&P 500 earnings come outside of the US.

- Record levels of profit margins of 10% with a ten-year average of 8.8% while overall earnings are falling, suggest there is further downside risk.[8]

[8] http://www.factset.com/websitefiles/PDFs/earningsinsight/earningsinsight_2.12.16

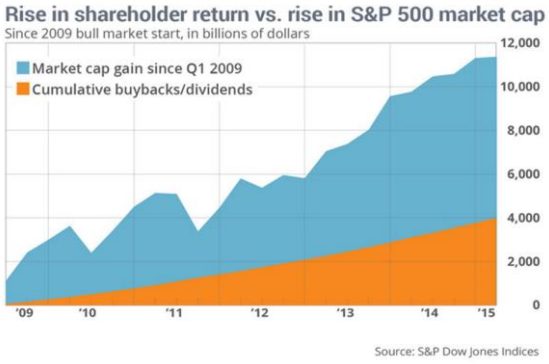
Even GAAP earnings appear to be higher due to unprecedented levels of buybacks and M&A

- Since 2009, US earnings have been significantly boosted by financial engineering made available through cheap money, zero interest rates and the abundance of credit. The combination of these three factors resulted in an unprecedented boom in mergers and acquisitions (M&A) and stock buybacks.

- S&P 500 companies **have spent about $2.4 trillion on buybacks** over the course of the current bull market – **14% of the market cap of the index**. In Q1 of 2015 companies spent more on buybacks than they earned. The last time this happened was in Q4 of 2008.

- Buybacks are not necessarily a bad thing. When done at the right price under the right circumstances they can increase shareholders' value. However, after the crisis, companies en masse have been using cheap credit to buy back their own shares at hefty valuations with the goal of making their earnings per share appear to be higher, simply because of the lower share count. Instead of investing in R&D, CAPEX and innovation, they chose to spend most of the money reducing their share count.

- The extent of buybacks in the current cycle is nothing short of astonishing. According to S&P **total buybacks and dividends (reinvested) have accounted for 35% of the buildup in market cap** for the S&P 500 since it bottomed out in 2009. Buybacks alone have accounted for **21% of the market cap's rise**:[9]



- 2015 was par excellence the best year for M&A with a record $4.5 trillion in worldwide deals.[10] Like buybacks, M&A can be positive for shareholders. In our view, numerous companies overreached in borrowing cheap debt simply to buy companies trading at lower PE ratios compared to their own, for the purpose of creating EPS accretion that is more of an illusion than reality.

- The increase in buybacks and M&A makes the market appear cheaper than it actually is, and its earnings higher than they truly are. Furthermore it makes historical comparisons much less effective.

[9] http://www.marketwatch.com/story/how-stock-buybacks-have-become-wall-streets-new-drug-2015-07-17
[10] http://www.wsj.com/articles/2015-becomes-the-biggest-m-a-year-ever-1449187101

Conclusion

- US earnings are falling and we are already 5 quarters into an earnings recession.
- However, the bigger issue for us is that the earnings of today's companies are of ominously poor quality. The officially quoted earnings numbers by economists, information agencies and the media at large are severely overstating the earnings power of US companies by using custom-tailored "adjusted" numbers that utilize increasingly more adjustments. The current 30% difference between adjusted and GAAP figures is a telling sign of the challenging macro environment. It is also strikingly similar to the difference between GAAP and adjusted earnings back in 2007, just before the last crisis.
- The illusory, non-GAAP numbers **make the market appear cheaper than it actually is**. When companies are reporting adjusted earnings so markedly different from GAAP earnings, investors are ultimately buying into hopes and dreams by paying more than they realize. The table below demonstrates that the market is actually trading closer to 21x trailing earnings rather than the widely advertised figure of 16x.

	2015	P/E ratio at index level of 1900
Thomson Reuters EPS	$117.28	16.2x
Factset EPS	$118.36	16.1x
GAAP EPS	$90.57	**21.0x**

- Wall Street and the media hold that at 16x trailing earnings the S&P is not that expensive since it is close to the historical average of 15x. Since far fewer companies reported adjusted earnings before the year 2000, this historical comparison is nonsensical. Before the year 2000, most companies reported only GAAP figures so today's GAAP number is more useful in comparing historical data.
- In addition, having so many companies reporting adjusted earnings is a very recent phenomenon that accelerated in the past 5 years. Many investors are not aware of its implications and thus are ill equipped to watch out for the risk it entails.
- The final straw is that even GAAP earnings have been inflated by excessive M&A and stock buyback programs made possible by the proliferation of cheap money and loose credit policies.
- To recap, in the US market, we end up having artificially inflated adjusted numbers based on artificially inflated GAAP numbers that are all currently going down. Far from an optimistic scenario.