New Constructs®
Diligence | Independence | Performance

DILIGENCE PAYS 12/5/2016

Make ROIC Great Again

As tireless advocates for the importance of Return on Invested Capital (ROIC), we've been encouraged to see a growing appreciation for the metric in the investment community. Most recently, ROIC ranked as the most important metric for investment decisions according to a survey of global investors.

Unfortunately, many investors may be relying on flawed calculations of ROIC. Our research on this topic took us to a remarkable Morningstar (MORN) forum thread from 2011. The thread originated with a user who wanted to know why the company used net income rather than the correct non-operating profit after tax (NOPAT) as the numerator in the ROIC calculation. Over the course of several months:

- The Morningstar representative said the company's own analysts use NOPAT for their internal models.
- No satisfactory explanation was given for why the flawed calculation using net income remained the default for the public-facing website.
- One user wrote, "I would like to kindly remind you that M* is calculating return on invested capital (ROIC) in a way that is financially meaningless."
- Another user wrote, "M* is not the only service doing the ROIC calculation poorly - I can't find any other service using appropriate values."

While the last person must not have discovered New Constructs, it's true that the most firms offer ROICs with glaring flaws in their methodology or data.

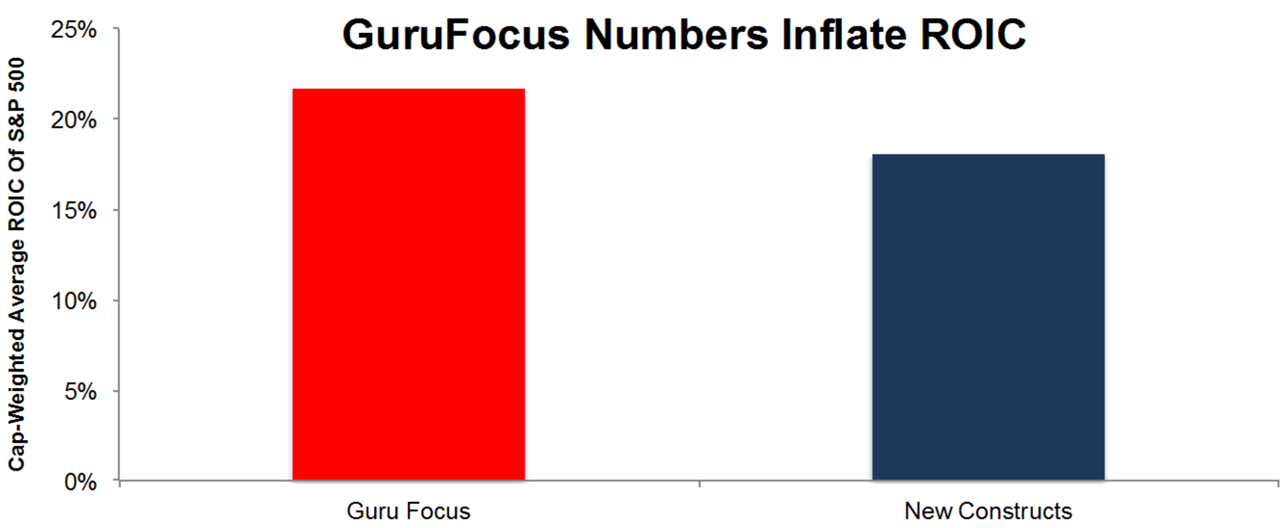
Reliance On Faulty Numbers

The Google search "TICKER ROIC" for almost any ticker shows GuruFocus as the first result. GuruFocus has a much better calculation than many of its competitors as it at least starts with the correct formula of NOPAT/Invested Capital.

At the same time, there's a big difference between claiming to use "NOPAT" and "Invested Capital," and actually calculating those numbers in an accurate and complete way. In the case of GuruFocus, its website shows that its NOPAT and Invested Capital are based on unscrubbed accounting numbers.

Without digging into the footnotes, it's impossible to calculate ROIC in way that is meaningful and comparable across companies. Figure 1 shows how GuruFocus tends to overstate ROIC for companies in the S&P 500.

Figure 1: Cap-Weighted Average ROIC For The S&P 500: Guru Focus Vs. New Constructs



Sources: New Constructs, LLC and company filings.

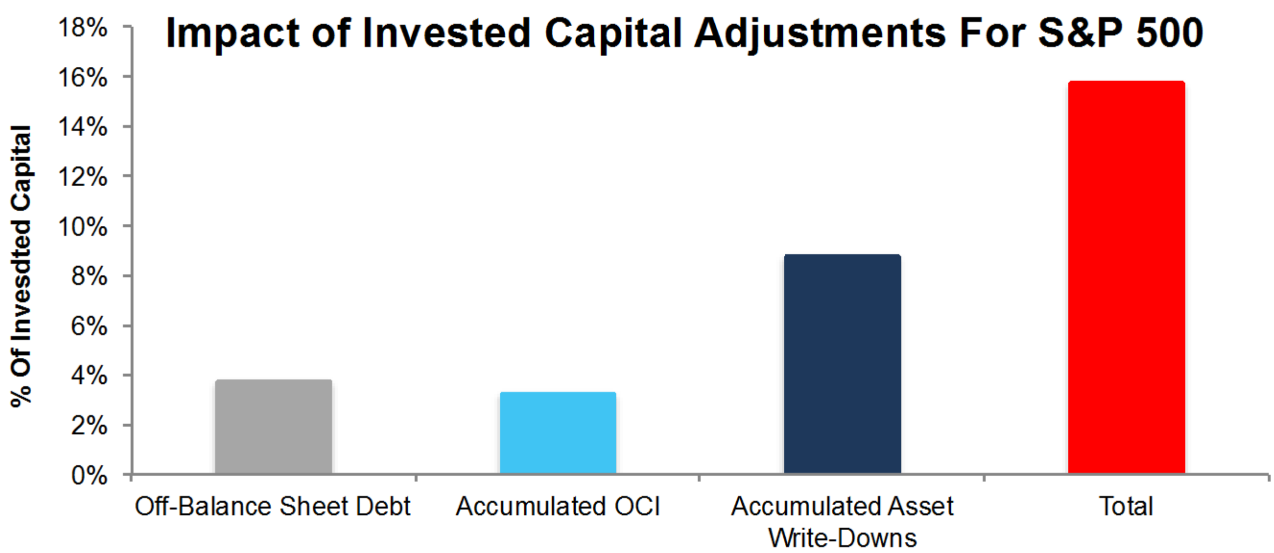
Most of the differences in ROIC comes from the fact that GuruFocus' definition of invested capital ignores a number of critical items. There are many loopholes companies can use to hide capital off the balance sheet and inflate ROIC.

Figure 2 shows three (out of a total of 12) of the largest adjustments we make to invested capital:

- Adding back off-balance sheet debt due to operating leases
- Removing accumulated other comprehensive income (OCI)
- Adding back accumulated asset write downs

Combined, these three items account for over 15% of all invested capital for S&P 500 companies.

Figure 2: Balance Sheet Adjustments Matter For Getting Invested Capital Right



Sources: New Constructs, LLC and company filings.

Faulty Numbers Lead To Faulty Analysis: "Garbage In, Garbage Out"

The TJX Companies (TJX) has one of the largest discrepancies between its ROIC on GuruFocus (63.26%) and our ROIC calculation (18.5%) for any S&P 500 company. This discrepancy comes largely from the three items above.

In particular, GuruFocus' failure to account for operating leases has a significant impact here. The site's calculation of invested capital—which includes only reported debt on the balance sheet, minority interest, and shareholder's equity—is just $3.8 billion. Meanwhile, the company has nearly $6.6 billion in off-balance sheet debt.[1]

Add in $700 million in accumulated OCI and $250 million in accumulated asset write downs, along with a couple other adjustments, and you end up with a true average invested capital of $13.1 billion, over three times the GuruFocus number.

This faulty methodology not only inflates ROIC, it also creates misleading comparisons. According to GuruFocus, TJX competitor Ross Stores (ROST) has a lower ROIC of 51.13%. However, that's mainly because ROST is less

[1] Note that FASB's new requirement to bring off balance sheet operating lease debt to the balance sheet in coming years does not fix this problem. This accounting rule change creates comparability issues between years where operating leases are on balance sheet and when they are not. In addition, after companies put operating leases on balance sheet, the myriad of different ways companies can value the operating lease debt will undermine the ability to rely on unadjusted accounting numbers to perform apples-to-apples comparisons. Our models address all of these issues and have done so for over a decade.

reliant on operating leases and has almost no accumulated write-downs or OCI. When we make these adjustments, we see that ROST is actually slightly more profitable than TJX, with an ROIC of 19.7%.

It's not just the invested capital side that has issues. GuruFocus' NOPAT calculation, which is just Operating Income*(1-Tax Rate) also fails to account for a number of important accounting loopholes.

For instance, General Electric (GE) has an annualized NOPAT of $15.7 billion and an ROIC of 14.18% on the site. GuruFocus fails to account for a $3.2 billion decrease in reserves and an abnormal situation that allowed the company to have a tax rate of effectively zero in the most recent quarter. Adjusting for these and other unusual items, GE actually has a NOPAT of $4.2 billion and an ROIC of 2.2%. GuruFocus numbers make it look as if GE is a thriving business while our diligence reveals that it is a struggling company in the midst of a major overhaul. More details on GE's ROIC can be found here.

Lack of Transparency… If The Work Is Good, Why Not Show Us?

We're not singling out GuruFocus for criticism. In fact, the site does a far better job of making its calculations clear and transparent than any of the others out there. This transparency makes it easy to contrast its methodology with our own.

By comparison, other sites have almost no transparency with their calculations. Finding the forum post with the Morningstar definition took intensive searching. Ycharts gives a perfunctory and incomplete definition. The Wall Street Journal gives no methodology and has a disclaimer at the bottom that the data is not intended for trading purposes and that the data provider is not liable for any errors.

Lots of sites claim to provide ROIC, but few are willing to show the formulas or data underlying their calculation. We can only guess as to why they are not transparent…but it is probably because they know their methodology doesn't hold up to rigorous scrutiny.

Calculating ROIC (The Right Way) Is Hard

We documented many of the difficulties involved in calculating ROIC back in January in "If ROIC Is So Great, Then Why Doesn't Everyone Use It?" There's been an awareness of the importance of ROIC and a demand for a rigorous calculation ever since the 1990's.

The technology didn't exist to perform the ROIC calculation with integrity on a large scale back then. Even today, it's still extremely difficult. Technologies such as XBRL that were supposed to make the process of parsing filings easier are not yet sophisticated enough to be useful.

GuruFocus, Morningstar, YCharts, The Wall Street Journal: these firms are organized around certain goals, and they do them well. Calculating ROIC is not a priority for any of them, and as such they tend to get it wrong.

On the other hand, New Constructs was built with a singular focus on providing high-integrity calculations of ROIC. Our technology, our people, our whole organization are built to provide investors, consultants and advisors with the highest quality data and the most rigorous calculation of ROIC.

This article originally published here on December 5, 2016.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensic accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.