# Earnings Distortion Makes This Stock A Buy

Research from Harvard Business School and MIT Sloan shows earnings for the S&P 500 were distorted by an average of 22% in 2018. We've crunched the numbers and put together an Earnings Distortion Scorecard[1] for all firms in the S&P 500. This scorecard shows how much unusual gains/losses distort each firm's 2018 earnings.

The Earnings Distortion Scorecard identified a company whose significantly understated earnings and cheap valuation give it a higher chance of beating earnings in the short-term and outperforming the market in the long-term. AmerisourceBergen Corp (ABC: $89/share), is this week's Long Idea.

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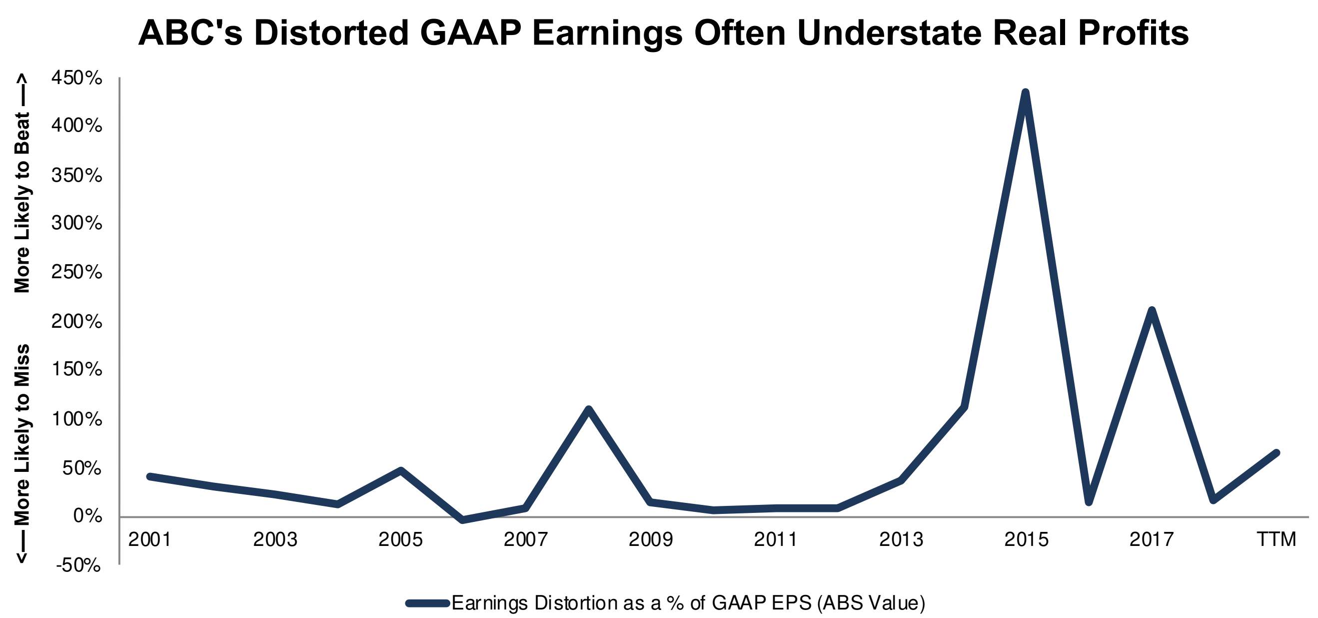
### A Stock Likely to Beat Expectations Due to Distorted Earnings

Our research shows AmerisourceBergen is a stock investors should look to buy ahead of its fiscal 4Q19 earnings report on November 7.

ABC's reported GAAP earnings have consistently understated the firm's true profitability, in large part due to significant unusual gains/losses hidden in the footnotes. Figure 1 provides a historical look at the magnitude of earnings distortion in ABC's GAAP earnings. As earnings distortion from hidden expenses increases, so does the level of earnings understatement and the likelihood a firm will beat street earnings, which the HBS & MIT Sloan paper shows do not capture most unusual items.

**Figure 1: ABC Earnings Distortion as % of GAAP EPS – Absolute Value of Distortion**




Sources: New Constructs, LLC and company filings

Since 2013, the number and size of unusual losses for ABC have soared, and the company's reported profits have understated its core earnings.

[1] Earnings Distortion approximates the Total Adjustments featured in the HBS & MIT Sloan paper. See the final section of this report and the Appendix for more details on the adjustments used in this report and the HBS & MIT Sloan paper.



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The recipient of this report is directed to read these disclosures.

These unusual losses have coincided with a strong run of earnings beating expectations. ABC has beaten EPS expectations in 17 of the last 19 quarters, dating back to fiscal 1Q15. It seems likely that the company's understated GAAP earnings have led analysts to be overly pessimistic in their forecasts.

As Figure 1 shows, ABC's earnings are distorted by 67% over the TTM, a significant increase from just 17% in 2018. For reference, the S&P earnings were distorted by an average of 22% in 2018. The company's understated earnings lead us to believe it is more likely than not to beat earnings expectations when it reports on November 7.

**Why is earnings data wrong?**

In "Core Earnings: New Data and Evidence," Ethan Rouen and Charles Wang from HBS and Eric So from MIT Sloan show that traditional data providers and analysts are missing or mis-categorizing a very material and growing amount of unusual gains/losses.

> "…many of the …{unusual gains/losses} collected by New Constructs do not appear to be easily identifiable in Compustat…" – page 13

The authors show the market is inefficiently assessing earnings because too few people read financial footnotes. These footnotes contain important information that is required to measure reported and core earnings accurately.

**Breaking Down ABC's Earnings Distortion**

Over the TTM period, ABC had $635 million in net unusual expense adjustments that cause earnings to be understated. Notable unusual gains and losses include:

- $570 million ($2.68/share) in impairment of long-lived assets that decrease reported earnings – Page 3 2Q19 10-Q
- $55 million ($0.26/share) in employee severance, litigation, and other expenses that decrease reported earnings – Page 3 2Q19 10-Q
- $14 million ($0.07/share) in other income that increase reported earnings – Page 3 2Q19 10-Q

We identified $3.01/share in unusual expenses that artificially decrease reported and core earnings over the TTM. This net unusual expense is slightly offset by $0.04/share in unusual income. In total, we identified $2.97/share in net unusual expense in ABC's TTM results. After total adjustments, we see that ABC's TTM earnings of $7.45/share are significantly higher than $4.47/share in reported earnings.

**Understated Earnings + Cheap Valuation = Quality Risk/Reward**

With a price-to-earnings (P/E) ratio of 20, ABC appears undervalued by traditional metrics. The Healthcare sector has an average P/E ratio of 29 and the S&P 500 average sits at 22. ABC looks even cheaper when using earnings of $7.45/share (as opposed to reported earnings), as its P/E ratio falls to 12.

ABC's cheap valuation means the stock still has significant potential upside. At its current price of $89/share, the stock has a price-to-economic book value (PEBV) ratio of 1.1. This ratio means the market expects the company's after-tax operating profit (NOPAT) to grow by no more than 10% over the remaining life of the firm. This expectation seems rather pessimistic given that ABC has grown NOPAT by 9% compounded annually over the past decade, and 15% compounded annually since 2001.

Our reverse discounted cash flow (DCF) model more rigorously assesses the valuation of this stock by quantifying the expectations for future profit growth baked into the stock price.

If ABC can maintain its 2018 NOPAT margin of 0.8% (below the 0.9% average of past five years) and grow NOPAT by just 5% compounded annually (nearly half its NOPAT growth over the past decade) for the next decade the stock is worth $113/share today, a 27% upside to the current stock price. See the math behind this reverse DCF scenario.

The combination of understated earnings and a cheap valuation earns ABC our Attractive rating.

**How You Can Leverage the Earnings Distortion Scorecard**

> "Trading strategies that exploit {adjustments provided by New Constructs} produce abnormal returns of 7-to-10% per year." – Abstract, 4th sentence

The paper presents a long/short strategy that holds the stocks with the most understated EPS and shorts the stocks with the most overstated earnings. Positions are opened in the month each 10-K is filed and held until the next 10-K is filed, or about a year.

This simple, low turnover strategy produced abnormal returns of 7-to-10% a year. These abnormal returns show that the market misses important data in the footnotes and that investors who adjust for unusual items can make more money.

**Defining Earnings Distortion in This Analysis**

In this report, Total Adjustments includes:

+ Acquisition and Merger Expenses, net

+ Foreign Currency Expenses, net

+ Legal Regulatory and Insurance Expenses, net

+ Company Defined Other Expenses, net

+ Other Non-Recurring Expenses, net

+ Other Real Estate Owned Expenses, net

+ Other Financing Expenses, net

+ Derivative Related Expenses, net

+ Pension Related Expenses, net

+ All Restructuring Expense, net

+ Minority Interest Expense, net

+ Preferred Dividends, net

See Figure I in Appendix 1 for the definition of core earnings and total adjustments used in the HBS & MIT Sloan paper.

We further breakdown each of the adjustment categories above in Figure II of Appendix 1. This level of granularity allows investors to get a clear picture of all adjustments required to calculate a firm's true earnings.

Appendix 2 provides details on the most complete data set we offer clients here.

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

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## Appendix 1

Figure I contains the definition of core earnings used in the HBS & MIT Sloan paper. Certain adjustment categories we included in the analysis above were aggregated into the definition below. We believe breaking out these adjustments is necessary to ensure all necessary adjustments are captured and accounted for in calculating core earnings.

**Figure I: Core Earnings Defined in the HBS & MIT Sloan Paper**

*Earnings*, as follows:

$$\begin{aligned}
\textit{Core Earnings}_{i,t} &= \textit{Net Income}_{i,t} + \textit{Total Adjustments}_{i,t}, \qquad (1)\\
\text{where } \textit{Total Adjustments}_{i,t} &= \textit{Net Acquisition Expenses}_{i,t}\\
&+ \textit{Net Currency Expenses}_{i,t}\\
&+ \textit{Net Discontinued Ops Expenses}_{i,t}\\
&+ \textit{Net Legal Expenses}_{i,t}\\
&+ \textit{Net Pension Adjustments}_{i,t}\\
&+ \textit{Net Restructuring Expenses}_{i,t}\\
&+ \textit{Net Company-Defined Other Expenses}_{i,t}\\
&+ \textit{Net Other Expenses}_{i,t}.
\end{aligned}$$

Sources: Core Earnings: New Data and Evidence

Figure II details each specific adjustment type included in the total adjustments we detailed in this report.

**Figure II: Breakdown of Adjustment Categories**

The hidden and reported adjustment categories included in Total Adjustments defined earlier can be further broken down into the following adjustments:

1. Acquisition and Merger Expenses, net
2. Foreign Currency Expenses, net
3. All Restructuring Expenses, net
    a. Write-downs
    b. Discontinued Operations
    c. Other Restructuring
4. Legal, Regulatory, and Insurance Expenses, net
5. Pension Related Expenses, net
    a. Recurring
    b. Non-Recurring
6. Company Defined Other Expenses, net
7. Other Non-Recurring Expenses, net
8. Other Real Estate Owned Expenses, net
9. Other Financing Expenses, net
10. Derivative Related Expenses, net
11. Minority Interest Expenses, net
12. Redeemable Preferred Dividends, net

Sources: New Constructs, LLC

## *Appendix 2*

The HBS paper focuses on core earnings for direct comparison with GAAP earnings, IBES and First Call earnings, and Compustat's "income before extraordinary items" and "income minus special items". Our preferred measure of profitability, net operating profit after tax (NOPAT), incudes all the items in the HBS & MIT Sloan paper as well as several others. Our complete reconciliation of GAAP net income to NOPAT is below. To purchase this data for nearly all U.S. stocks from 1998 – 2018 click here.

**Reported GAAP Net Income**

*Total Net Non-Operating Expenses Hidden in Operating Earnings*

+ Hidden Total Restructuring Expenses, net
+ Hidden Foreign Currency Expenses, net
+ Hidden Other Real Estate Owned Expenses, net
+ Hidden Acquisition and Merger Expenses, net
+ Hidden Legal, Regulatory and Insurance Expenses, net
+ Hidden Derivative Related Expenses, net
+ Hidden Other Financing Expenses, net
+ Hidden Other Non-Recurring Expenses, net
+ Hidden Recurring, Non-Operating Pension Expenses, net
+ Hidden Non-Recurring Pension Expenses, net
+ Hidden Company Defined Other Expenses, net

*Reported Net Non-Operating Expenses*

+ Reported Derivative Related Expenses, net
+ Reported Other Financing Expenses, net
+ Reported Company Defined Other Non-Operating Expenses, net
+ Reported Acquisition and Merger Expenses, net
+ Reported Legal, Regulatory, and Insurance Related Expenses, net
+ Reported Interest Expense/(Income), net
+ Reported Expenses/(Income) from Discontinued Operations, net
+ Reported Losses/(Income) from Unconsolidated Subsidiaries, net
+ Reported Foreign Currency Loss/(Gain), net
+ Reported Non-Operating Other Real Estate Owned Expense/(Income), net
+ Reported Other Non-Operating Expense/(Income), net
+ Reported Write-Downs, net
+ Reported Restructuring Expense, net
+ Reported Other Non-Recurring Expense/(Income), net

*Derived Datapoints*

+ Change in Total Reserves
+ Goodwill Amortization Expenses, net
- ESO Expense (Employee Stock Options), net
+ Interest for PV of Operating Leases
+ Quarterly/Annual Classification Disclosure Adjustments, net
+ Non-Operating Tax Adjustment

*Net After-Tax Non-Operating Expense/(Income)*

+ Reported Minority Interest Expenses, net
+ Reported Loss/(Gain) from Discontinued Operations, net
+ Reported Preferred Stock Dividends, net
+ Reported Redeemable Preferred Stock Dividends, net
+ Reported Other After-tax Charges, net

= **NOPAT (Net Operating Profit After Tax)**

## *Footnotes adjustments matter. We are the ONLY source.*

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

**HBS & MIT Sloan research reveals that:**

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Quotes from HBS & MIT Sloan professors on our research:

### *Get better research:*

*"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications."* – page 19

### *Pick better stocks:*

*"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract*

### *Avoid losses from using other firms' data:*

*"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 13*

### *Build better models:*

*"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 3-4*

### *Exploit market inefficiencies:*

*"These results suggest that the adjustments made by analysts to better capture core earnings are incomplete, and that the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26*

### *Fulfill fiduciary duties:*

*"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 31*

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