"Novel Dataset" Reveals Undervalued Tech Giant

"Trading strategies that exploit [non-recurring] earnings produce abnormal returns of 7-to-10% per year."
- "Core Earnings: New Data and Evidence"

In "Core Earnings: New Data and Evidence", Ethan Rouen and Charles C.Y. Wang of Harvard Business School (HBS) and Eric So of Massachusetts Institute of Technology (MIT) Sloan School of Management show that:

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

In this report, we leverage our Robo-Analyst technology and "novel dataset" to highlight a tech giant that is significantly more profitable than its earnings suggest. Qualcomm (QCOM: $78/share) is this week's Long Idea.

GAAP Earnings Mislead Investors

GAAP earnings are distorted by non-recurring income and expenses, as well as a number of loopholes that allow executives to "manage" (i.e. manipulate) earnings.[1]

Non-GAAP earnings are even worse. When companies get to make their own rules, they regularly exclude operating expenses to overstate earnings.

We solve this problem by combining machine learning technology with human expertise to comb through every 10-K and 10-Q for over 2,800 companies to create an unrivalled dataset of non-recurring expenses and income. As the HBS paper attests:

"…this is the most comprehensive dataset that captures what a fundamental analyst would be likely to identify as transitory or non-operating earnings items…"

Our analysis of QCOM's most recent 10-K reveals nearly $3.9 billion (12% of total assets and $3.17 per share) in net non-recurring expenses. On a trailing twelve months (TTM) basis, QCOM had $2.1 billion (6% of total assets) in net non-recurring expenses.

Below we'll walk through the adjustments we made to QCOM's 10-K that are used to calculate Core Earnings featured the HBS paper. The formula for Core Earnings is shown in Figure 1.

[1] From page 1 of the paper: "Some components of earnings reported in firms' 10Ks and 10Qs are likely persistent over time, stemming the core operations of the firm, whereas others reflect transitory shocks and are unlikely to persist."

Figure 1: The Formula for Core Earnings

$$\begin{aligned} Core\ Earnings_{i,t} &= Net\ Income_{i,t} + Total\ Adjustments_{i,t}, \\ \text{where } Total\ Adjustments_{i,t} &= Net\ Acquisition\ Expenses_{i,t} \\ &+ Net\ Currency\ Expenses_{i,t} \\ &+ Net\ Discontinued\ Ops\ Expenses_{i,t} \\ &+ Net\ Legal\ Expenses_{i,t} \\ &+ Net\ Pension\ Adjustments_{i,t} \\ &+ Net\ Restructuring\ Expenses_{i,t} \\ &+ Net\ Company\text{-}Defined\ Other\ Expenses_{i,t} \\ &+ Net\ Other\ Expenses_{i,t}. \end{aligned}$$

Sources: Core Earnings: New Data and Evidence

Net Acquisition Expenses

QCOM disclosed $782 million (2% of total assets) in net acquisition expenses in 2018.

These non-recurring expenses, disclosed on page 41 of the financial footnotes (page 109 overall), were classified as follows:

- $449 million in cost of revenues (4% of total cost of revenues)
- $6 million in research and development expenses (<1% of research and development expense)
- $327 in selling, general, and administrative expenses (11% of SG&A)

Net Currency Expenses

QCOM disclosed a net gain of $37 million (<1% of total assets) on foreign currency transactions in 2018.

This foreign currency gain was disclosed on page 20 of the financial footnotes (page 88 overall).

Net Discontinued Operations Expense

QCOM did not disclose any discontinued operations expenses in 2018.

Net Legal Expenses

QCOM did not disclose any legal expenses in 2018.

Net Pension Adjustments

QCOM did not disclose any pension adjustments in 2018.

Net Restructuring Expenses

QCOM disclosed a net gain of $49 million (<1% of total assets) on restructuring items in 2018.

This net gain, disclosed on page 20 of the financial footnotes (page 88 overall), consists of:

- $124 million in realized gains on marketable securities and other investments, partially offset by
- $75 million in impairment losses on marketable securities and other investments

Net Company-Defined Other Expenses

QCOM disclosed $3.1 billion (10% of total assets) in company-defined other expenses on its income statement in 2018.

By far the largest component of QCOM's "Other Expenses" was the $2 billion breakup fee it paid as part of its failed merger with NXP Semiconductors. The company incurred this charge in Q4 2018, which means the fine still impacts TTM earnings.

Net Other Expenses

QCOM disclosed $27 million (<1% of total assets) in other expenses that we classified as non-recurring in 2018.

This expense consisted of $27 million in losses on derivative instruments, disclosed on page 20 of the financial footnotes (page 88 overall).

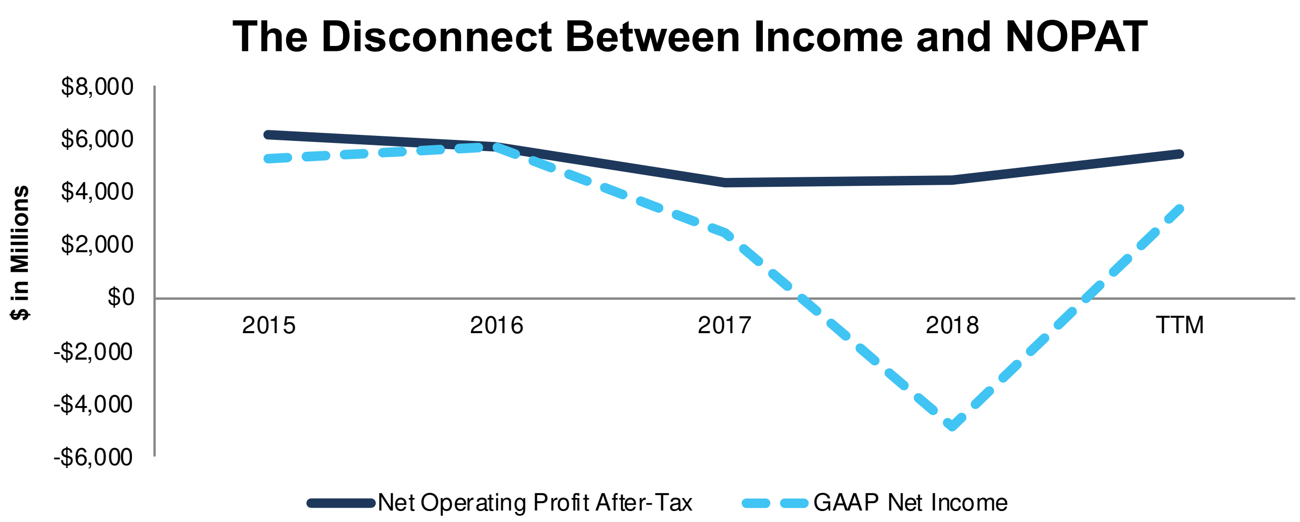
But Wait… There's More

In addition to the adjustments made to calculate "Core Earnings" in the HBS paper, we identified one other significant adjustment. On page 21 of the financial footnotes (page 89 overall), QCOM disclosed $5.7 billion (17% of total assets) in charges due to U.S. tax reform.

The authors of the HBS paper did not include our tax adjustments, so this item is not included in their analysis. However, at 17% of total assets and $4.67 per share, it clearly had a significant impact on QCOM's 2018 GAAP earnings, and it continues to impact the company's TTM earnings.

Figure 2 shows that QCOM's GAAP net income remains significantly below its net operating profit after tax (NOPAT).

Figure 2: QCOM NOPAT vs. GAAP: 2015-TTM



Sources: New Constructs, LLC, and company filings

Our analysis shows that QCOM's GAAP net income significantly understates the company's true profitability.

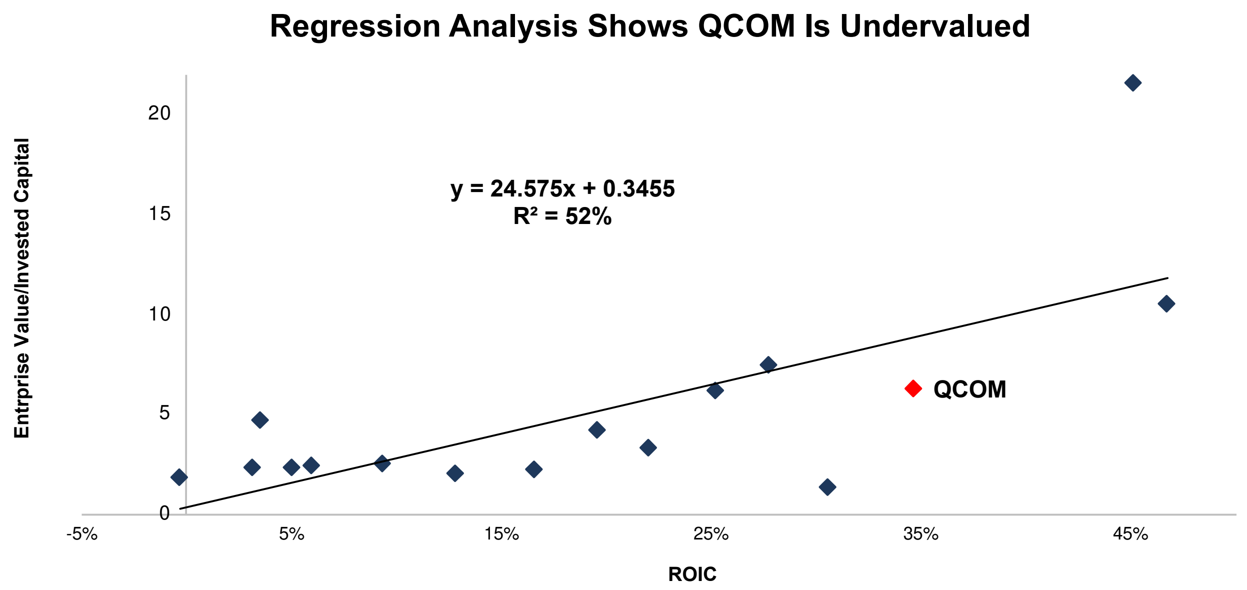
High Quality Corporate Governance

In addition to its understated earnings, Qualcomm's corporate governance is impressive. The company ties ~25% of total executive compensation to 3-year average return on invested capital (ROIC). ROIC is the best metric for aligning executive's interests with those of long-term shareholders because it has the clearest link to valuation, and it incentivizes executives to be responsible stewards of shareholder capital.

Numerous case studies show that getting ROIC right is an important part of making smart investments. This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up. The technology that enables this research is featured by Harvard Business School.

Per Figure 3, ROIC explains 52% of the difference in valuation for the 16 large cap semiconductor companies we cover. QCOM trades at a discount to peers as shown by its position below the trend line.

Figure 3: ROIC Explains 52% of Valuation for QCOM Peers



Sources: New Constructs, LLC, and company filings

If QCOM were to trade at parity with its peers, the stock would be worth $111/share today, a 42% upside to the current stock price.

Our reverse discounted cash flow model reveals the stock has significant upside potential as well. If QCOM can maintain its 2018 NOPAT margin of 20%, and grow NOPAT by 7% compounded annually over the next decade (in-line with its growth rate over the past 10 years), the stock is worth $91/share today, a 16% upside to the current stock price. See the math behind this dynamic DCF scenario.

Exploit Market Inefficiency

The HBS paper clearly shows an inefficiency in the market. The paper's abstract states:

> "*Analysts and market participants are slow to impound the implications of transitory earnings*."

Our research gives investors the ability to identify these transitory earnings and find companies, like QCOM, that are more profitable than would first appear and are undervalued.

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

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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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