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Earnings Distortion Alert: This Pharmacy Giant Has Understated Earnings

New research from Harvard Business School and MIT Sloan uses our database of footnotes disclosures, the ONLY one in the world, to show S&P500 companies distort their earnings by an average of 22%.

Companies get away with misleading the markets because too few investors read the financial footnotes. And honestly, who can blame them - who has time to read filings that can be 200+ pages long? That's why we have spent the last 19 years training our machine learning engine to read SEC filings and pull out thousands of datapoints. Using our proprietary footnotes database, we created an Earnings Distortion Scorecard[1] to show how much unusual gains/losses distort Street earnings and find companies with significantly under/overstated earnings.

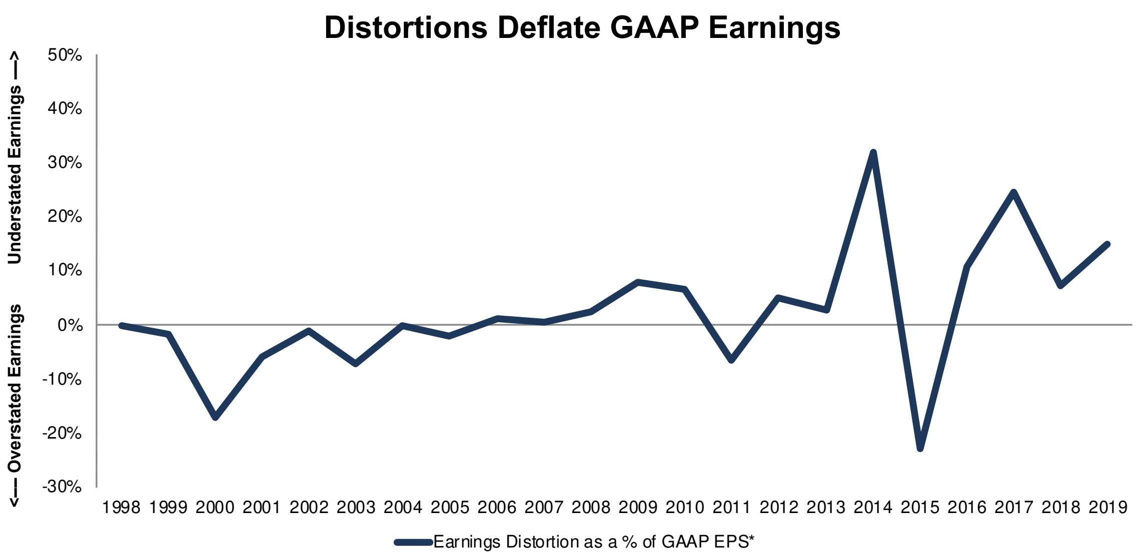
Our Earnings Distortion Scorecard reveals this stock has significantly understated earnings. Further, our reverse discounted cash flow (DCF) model reveals it has a cheap valuation. A few smart private equity firms appear to agree. Investors should look to buy this stock ahead of its fiscal 1Q20 earnings report on December 18, 2019. Walgreens Boots Alliance (WBA: $62/share) is this week's Long Idea.

Get the Data Featured by HBS & MIT Sloan

A Stock with Understated TTM Earnings

WBA's reported GAAP earnings have understated the firm's true profitability in eight of the past 10 years, and each year since 2016. In 2019, earnings were understated by 15%, in large part due to unusual expenses hidden in the footnotes and reported directly on the income statement. Figure 1 provides a historical look at the magnitude of earnings distortion in WBA's GAAP earnings.

Figure 1: WBA Earnings Distortion – 2019 Significantly Understated



Sources: New Constructs, LLC and company filings
*The formula for Earnings Distortion as a % of GAAP EPS uses the absolute value of GAAP EPS.

[1] Earnings Distortion captures all the non-recurring adjustments featured in the HBS & MIT Sloan paper. More details here.

As unusual expenses increase, so does the level of earnings understatement in GAAP and street earnings. Note that HBS and MIT Sloan empirically prove that street earnings do not capture 40%+ of unusual items.

Without these unusual expenses dragging down earnings, the likelihood that WBA beats earnings expectations increases because the real fundamentals of the business are stronger than street earnings suggest.

Why Earnings Data is Wrong and Our Data is the Most Accurate

In "Core Earnings: New Data and Evidence," Ethan Rouen and Charles Wang from HBS and Eric So from MIT Sloan show that corporate managers use non-operating and less persistent income-statement items to manipulate earnings.

"Street earnings for firms that meet or just beat analyst expectations are more likely to selectively exclude these items [non-operating and less persistent income-statement items]." – Abstract

Furthermore, the authors show that only New Constructs research includes the footnotes data needed to get the truth about earnings. 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 14

In other words, companies manipulate earnings and 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. Only New Constructs accurately identifies and adjusts for these footnote disclosures

Breaking Down WBA's Earnings Distortion

In fiscal 2019, WBA had $601 million in net earnings distortion that cause earnings to be understated. Notable unusual expenses found in the firm's 2019 10-K include:

- $477 million in transformational cost management expenses primarily recorded in SG&A – Page 47
- $303 million in acquisition-related costs – Page 47
- $196 million in store optimization costs primarily recorded in SG&A – Page 47
- $73 million in impairment charges on its pharmacy licenses primarily recorded in SG&A – Page 80

The transformational cost management expenses are part of WBA's Transformational Cost Management Program, which aims to deliver over $1.8 billion in costs savings by fiscal 2022. Similarly, the store optimization costs are part of WBA's Store Optimization Program, which aims to close around 750 stores in the company's Retail Pharmacy USA segment.

In total, we identified $0.65/share in net unusual expenses in WBA's 2019 results. After removing this earnings distortion from GAAP net income, we see that WBA's 2019 core earnings of $4.96/share are significantly higher than $4.31/share in reported earnings.

Follow the "Smart" Money – Rigorous Analysis Reveals Value

On November 5, 2019, Reuters first reported private equity interest in buying out Walgreens Boots Alliance. On November 11, Bloomberg reported that KKR & Co. formally approached WBA about a deal to take the company private.

Investors only looking at reported earnings may be confused by any private equity firm's interest in WBA. However, as Figure 1 shows, WBA's earnings have been significantly understated in recent years, and private equity firms could be getting an excellent deal at current prices.

WBA's net after-tax operating profit (NOPAT) was over $6.4 billion in 2019 (compared to just $4 billion GAAP net income) and the firm generates significant free cash flow to invest in new operations or pay dividends in a leveraged buyout scenario. Since acquiring Boots Alliance in 2015, WBA has generated $29.4 billion (53% of market cap) in FCF.

When we look at the expectations implied by its valuation, WBA looks cheap, even after the brief bump caused by the private equity interest. Its economic book value, or no growth value, is **nearly $80/share, which is 29% above the current stock price**, and higher than JPMorgan's estimated deal value of $75/share.

Upside Potential Is High Even Without Private Equity

With a price-to-earnings (P/E) ratio of 14.5, WBA appears undervalued by traditional metrics. The Consumer Non-cyclicals sector has an average P/E ratio of 27.9 and the S&P 500 average sits at 22.3. WBA looks even cheaper when we remove earnings distortion as its P/E ratio falls to 13.3.

WBA's cheap valuation means the stock still has significant potential upside. At its current price of $62/share, the stock has a price-to-economic book value (PEBV) ratio of 0.8. This ratio means the market expects the company's NOPAT to permanently decline by 20%. This expectation seems rather pessimistic given that WBA has grown NOPAT by 7% compounded annually over the past decade and 10% compounded annually over the past 20 years.

Even consensus estimates are not as negative on WBA as the stock's valuation implies. Analysts expect fiscal 2020 EPS to fall less than 1% YoY and grow by over 4% YoY in fiscal 2021.

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 WBA can maintain its 2019 NOPAT margin of 4.7% and grow NOPAT by just 3% compounded annually (less than half its NOPAT growth over the past decade) for the next decade, the stock is worth $95/share today, a 53% upside to the current stock price. See the math behind this reverse DCF scenario.

The combination of understated earnings and a cheap valuation earns WBA 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

Core Earnings: New Data and Evidence 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. Click here for more details on our data offerings.

We have already used the Scorecard to identify two very successful Long Ideas:

- AbbVie (ABBV), which beat street estimates on November 1 and is already up 12% (compared to 3% for S&P 500) since our article.
- Qualcomm (QCOM), which beat street estimates on November 6 and is already up 17% (compared to 4% for S&P 500) since our article.

We've also used the Scorecard to identify the following earnings beats:

- HCA Healthcare (HCA): beat the street on October 29
- Arista Networks (ANET): beat the street on October 31
- DuPont (DD): beat the street on October 31
- Sysco (SYY): beat the street on November 4
- CVS Health (CVS): beat the street on November 6
- AmerisourceBergen (ABC): beat the street on November 7
- Booking Holdings (BKNG): beat the street on November 7
- Skyworks Solutions (SWKS): beat the street on November 12

Defining Earnings Distortion in This Analysis

In this report, Earnings Distortion includes:

Hidden Items, Net

+ Total Hidden Restructuring
+ Hidden Foreign Currency Expense
+ Hidden Other Real Estate Owned Expense

+ Hidden Acquisition and Merger Expense
+ Hidden Legal Regulatory & Insurance Expense
+ Hidden Derivative Related Expense
+ Hidden Other Financing Expense
+ Other Hidden Non-Recurring Expense
+ Total Hidden Recurring Pension
+ Total Hidden Non-Recurring Pension
+ Hidden Company Defined Other Expense
- ESO Expense (Employee Stock Options) prior to 2006

Reported Items Pre-Tax, Net

+ Derivative Related Expense
+ Other Financing Expense
+ Company Defined Other Non-Operating Expense
+ Acquisition & Merger Expense
+ Legal, Regulatory, and Insurance Related Expense
+ Expenses/(Income) From Discontinued Operations
+ Foreign Currency Loss/(Gain)
+ Non-Operating Other Real Estate Owned Expense/(Income)
+ Other Non-Operating Expense/(Income)
+ Write-Downs (non-operating)
+ Restructuring Expense
+ Other Non-Recurring Expense/(Income)
+ Goodwill Amortization prior to 2002

+ Income Tax Distortion

Reported Items After-Tax, Net

+ Loss/(Gain) From Discontinued Operations
+ Other After-tax Charge

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

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.

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

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

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), includes all the items in the HBS & MIT Sloan paper as well as several others. Our complete reconciliation of GAAP net income to NOPAT is in this data dictionary. To access this data for nearly all U.S. stocks from 1998 – 2018 click here.

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 20

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 14

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 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, 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 33-34

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