Two Stocks That Should Beat Earnings Expectations

General Electric (GE: $11/share) and Lam Research (LRCX: $289/share) are this week's Long Ideas.

These two stocks are likely to beat earnings expectations according to our new Earnings Distortion Scores. One is a struggling company that looks like a good short-term play, even though long-term prospects are uncertain. The other is one of our highest-conviction picks that we expect to outperform in both the short and long-term.

We measure earnings distortion using a proprietary human-assisted ML methodology featured in a recent paper from Harvard Business School (HBS) and MIT Sloan. This paper empirically shows that street earnings estimates are incomplete and less accurate since they do not consistently and accurately adjust for unusual gains/losses buried in footnotes. By adjusting for earnings distortion, we create a measure of core earnings that is more predictive of future earnings.

Starting the week of January 6, 2020, we'll highlight the Earnings Distortion scores for the important earnings releases for the following week. Our goal is to help investors combat increasingly material levels of earnings distortion. Earnings for the S&P 500 were distorted **by an average of 22%** in 2018, and we expect that trend to continue.

Earnings Distortion Highlights

Earnings season won't get into full swing until February, but there are still plenty of stocks that report earnings in January. Of those stocks, LRCX and GE both stand out for their negative earnings distortion – i.e. their reported GAAP earnings are below their recurring core earnings.

Figure 1: Two Stocks That Should Beat Expectations – LRCX & GE

Company	Ticker	EPS Estimate	Earnings Date	Earnings Distortion Score
Lam Research	LRCX	$3.84	1/22/20	Beat
General Electric	GE	$0.18	1/30/20	Beat

Sources: New Constructs, LLC and company filings

Although we expect both stocks to beat expectations, our long-term outlook for the two companies is very different.

Lam Research (LRCX)

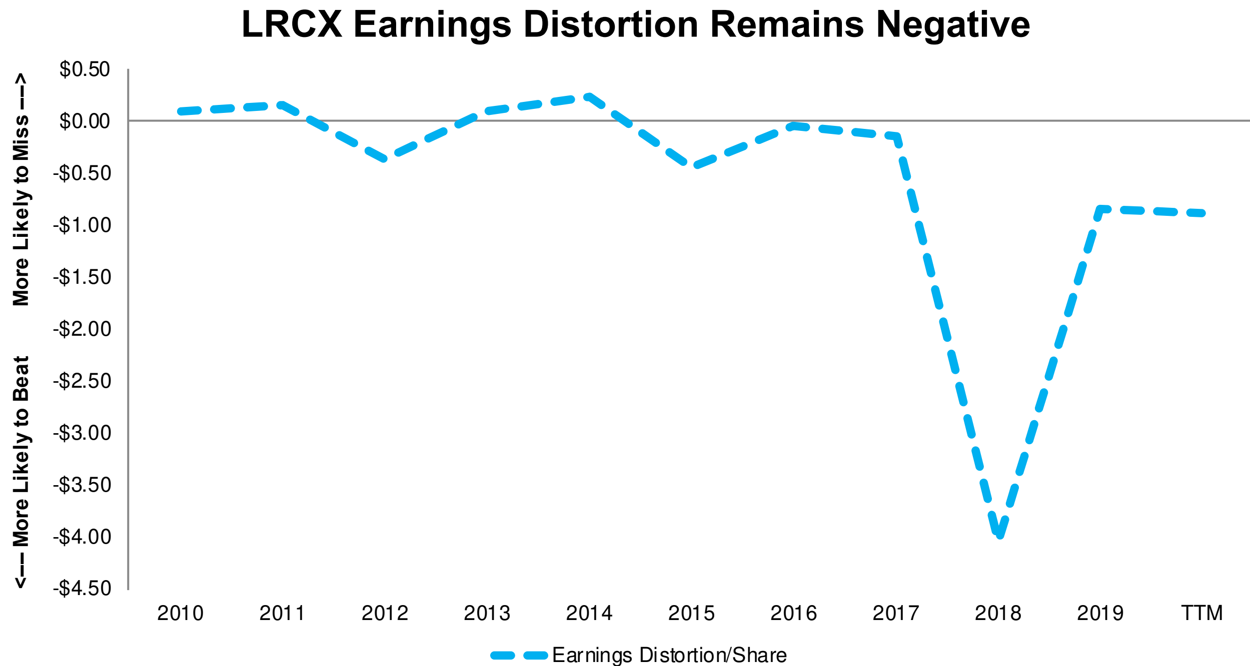
We first made Lam Research a Long Idea on May 23, 2018 in our article, "This Pick and Shovel Stock is Still a Value." Since our article, LRCX has outperformed the market, up 43% vs. the S&P 500 up 17%.

In our original article, we noted that LRCX's GAAP net income at the time was significantly understated due to a $704 million (6% of total assets[1]) non-recurring charge related to the corporate tax cut. This non-operating charge led to LRCX's GAAP net income understating its core earnings by $4.04/share in 2018, as shown in Figure 2.

[1] We weight earnings distortion by total assets to mirror the methods of "Core Earnings: New Data and Evidence", the recent paper from professors at Harvard Business School and MIT Sloan. That paper found used earnings distortion as a % of assets to create a long/short strategy that delivered abnormal returns of 7-10% annually.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

Figure 2: LRCX Earnings Distortion/Share: 2010-TTM



Sources: New Constructs, LLC and company filings

Most sophisticated investors likely understood that the tax law would have a big impact and were on the lookout for unusual tax charges in 2018. However, many investors probably don't realize that companies continue to face non-recurring tax charges as they update their estimates for the impact of the tax law.

In 2019, LRCX disclosed a $64 million (<1% of assets) tax charge as a result of U.S. tax reform.

Increasing the likelihood that LRCX beats earnings expectations, its comp for the upcoming quarter – 2Q 2020 – should be especially favorable. In the year ago quarter, the company disclosed a $22 million loss on deferred compensation plan assets.

Taken altogether, the TTM earnings distortion for LRCX totals -$139 million (1% of assets). On a per share basis, earnings are understated by $0.89/share, or 23% of consensus earnings estimates for Q2. Given this level of earnings distortion, LRCX looks well set up to beat expectations when it reports earnings on January 22.

Undervalued Stock

In addition to its compelling Earnings Distortion score for Q2 earnings, LRCX is undervalued and is also an appealing long-term investment idea.

The company's return on invested capital (ROIC) fell significantly from 61% in 2018 to 40% TTM due to a cyclical downturn in semiconductor demand. The semiconductor industry is notoriously cyclical, but we predicted in our original Long Idea that increasing consolidation in the industry should help to make future cycles less pronounced.

Sure enough, there are already signs that demand should rise again going into 2020. LRCX, as one of the leaders in the industry, should be well-positioned to recover as industry conditions improve.

Meanwhile, the growth expectations for the company are modest, as our dynamic DCF model shows.

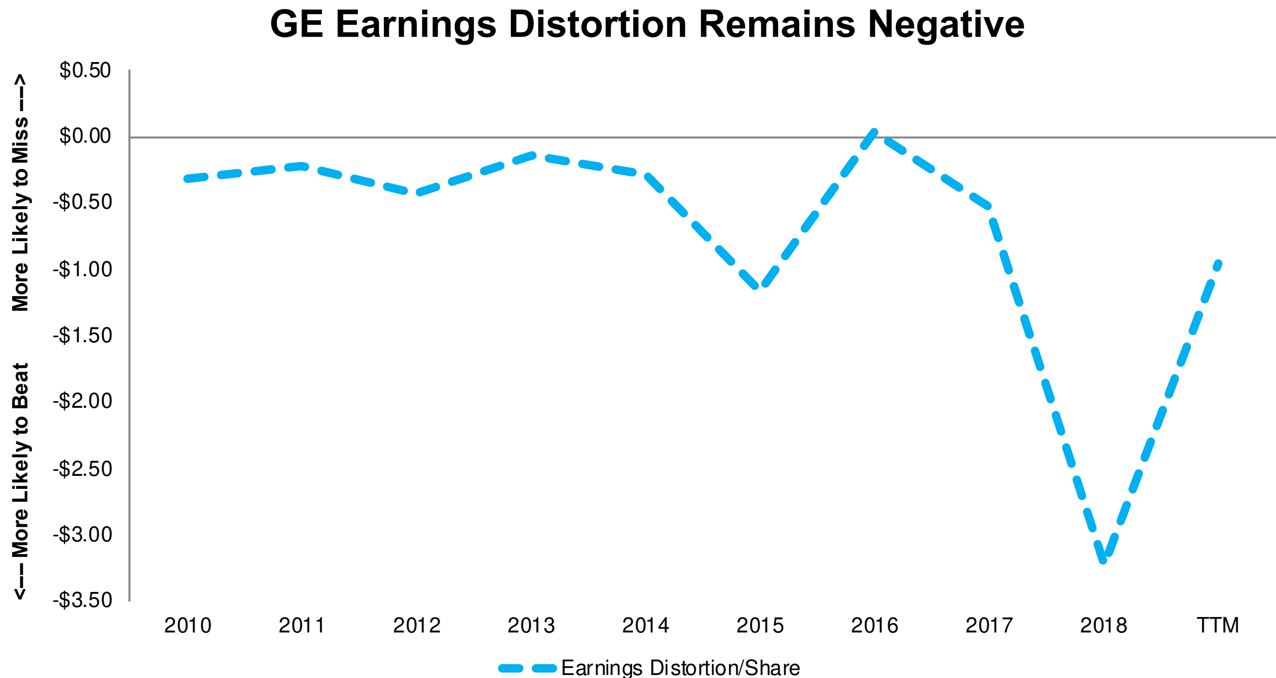
If LRCX can achieve its 2018 NOPAT margin of 28% (up from 24% TTM) and grow NOPAT by 8% compounded annually over the next decade, the stock is worth $320/share today, an 11% upside from the current stock price. See the math behind this dynamic DCF scenario.

8% annual growth may sound ambitious, but it's not all that optimistic for a company that has grown NOPAT by 30% compounded annually over the past five years. If semiconductor equipment demand recovers as expected, LRCX should be able to easily beat the growth expectations implied by its current valuation.

General Electric (GE)

Equity analysts sometimes use the term "kitchen sink quarter" to refer to the practice of troubled companies dumping as many expenses as possible into a single quarter to clear the books while sentiment for their stock is already negative. As Figure 3 shows, GE had a kitchen sink year in 2018.

Figure 3: GE Earnings Distortion/Share: 2010-TTM



Sources: New Constructs, LLC and company filings

In 2018, GE disclosed:

- $3.6 billion (1% of total assets) in restructuring charges
- A $1.5 billion (<1% of total assets) civil penalty
- A $200 million (<1% of total assets) warranty charge for its Gas Power Systems unit

Through the first nine months of 2019, GE also disclosed $8.1 billion (3% of total assets) in losses from discontinued operations.

As a result of these non-operating expenses, GE's GAAP loss is $5.4 billion over the TTM period, but its core earnings are positive at $3 billion. TTM GAAP EPS is -$0.62, but core earnings per share are $0.34.

Investors who just look at GAAP EPS might think that the consensus estimate of $0.18/share for 4Q2019 is optimistic, but our research shows that it's much closer to the company's actual profitability over the past year. GE looks poised to continue its run of strong earnings and beat expectations for the 4th straight quarter when it reports on January 30.

Still Causes for Concern

While GE looks like a good bet to beat upcoming earnings, we aren't necessarily optimistic about the company's long-term prospects. The company's massive restructuring and selling off of underperforming assets slightly helped its profits recover, but its ROIC of 3% remains well below the Industrials sector average of 8%.

Still, many of the company's units continue to struggle, including its Aviation unit, which faces a big potential hit from the ongoing 737 Max issues at major customer Boeing (BA).

At its current valuation of $11/share, GE has a price to economic book value (PEBV) of 1.2. This ratio means the market expects GE's NOPAT to grow by just 20% over the remaining life of the company. Those expectations may sound relatively low, but when you consider that GE's NOPAT has fallen by 10% compounded annually over the past decade, even modest profit growth expectations may be difficult for management to beat.

GE's current core earnings are much better than reported earnings, and the stock could get a good short-term bounce from its Q4 earnings report. However, the stock still looks risky for long-term investors.

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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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"…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:

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