Three Stocks That Could Surprise During Earnings Season

Our Earnings Distortion Scores indicate how likely companies are to beat or miss estimates based on how much their estimates contain unusual gains/losses which cause earnings to be over/understated.

Leveraging these scores, and our "novel dataset" of footnotes disclosures (featured in this Harvard Business School & MIT Sloan paper), we've identified three large-cap stocks that should surprise when they announce earnings over the coming weeks.

Qualcomm (QCOM) – Earnings Distortion Score: Strong Beat – Earnings Date: 2/5/20 after hours

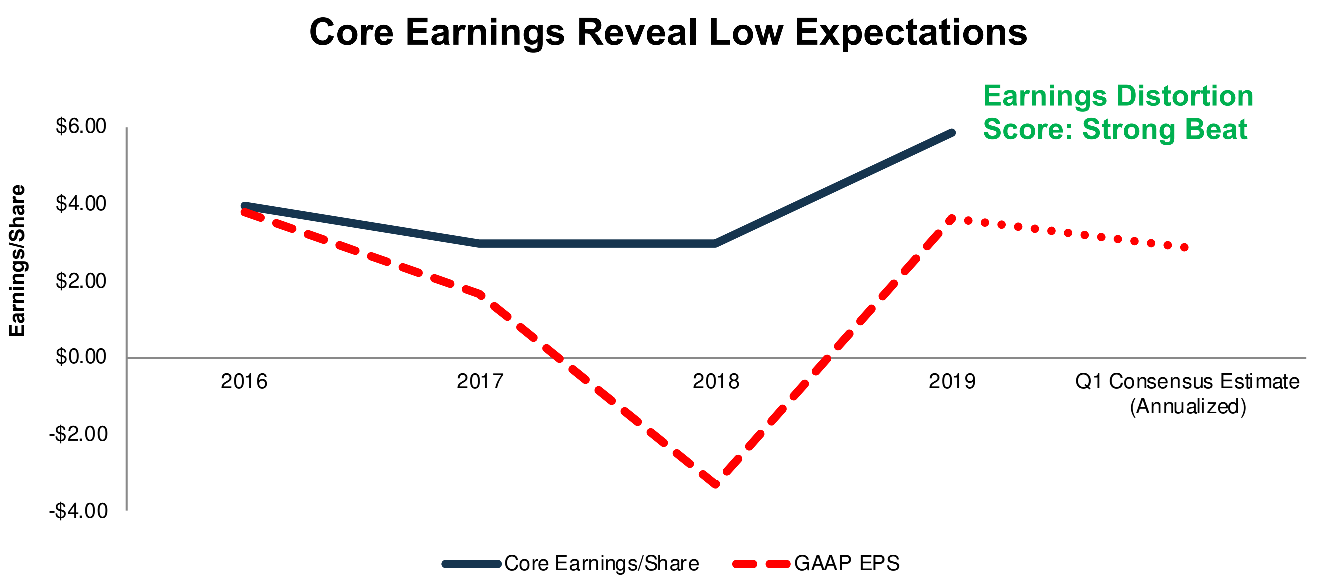
We previously featured QCOM as a Long Idea on October 16, 2019 in our article "Novel Dataset Reveals Undervalued Tech Giant." We showed at the time that the company's earnings were significantly understated and projected that it would beat expectations when it reported earnings in November.

Sure enough, QCOM had a strong earnings beat in Q4, and the stock is up 13% since our article vs. 9% for the S&P 500.

Now, after analyzing the company's 2019 10-K, we find that its earnings are still understated. In total, we identified $2.23/share (62% of reported EPS) in net unusual expenses in QCOM's 2019 results. After removing this earnings distortion from GAAP net income, we see that QCOM's 2019 core earnings of $5.83/share are significantly above its GAAP EPS of $3.60.

The analyst consensus for QCOM's Q1 2020 earnings is $0.71/share, which comes out to $2.84/share on an annualized basis. Based on GAAP earnings, current analysts' estimates imply a decline of 21% in annualized earnings. Figure 1 shows that, after removing earnings distortion, consensus estimates imply a much more significant decline of 51%.

Figure 1: QCOM Core Earnings Vs. GAAP: 2016-Q1 2020



Sources: New Constructs, LLC and company filings

Lam Research (LRCX) – Earnings Distortion Score: Beat – Earnings Date: 1/29/20 after hours

Most recently we featured LRCX in our December 18, 2019 article, "Two Stocks That Should Beat Earnings Expectations." We've previously featured LRCX as a Long Idea on June 12, 2017 in our article "Selling Shovels in a Gold Rush: Buy This Sector to Profit From the Internet of Things." We reiterated the stock in our article This Pick and Shovel Stock is Still a Value on May 23, 2018.

Since our original article in June 2017, LRCX is up 92% while the S&P 500 is up 35%.

In our recent article, we pointed out that LRCX's earnings are understated due to earnings distortion and that the stock should Beat earnings based on its Earnings Distortion score.

Over the trailing twelve months (TTM) period, LRCX had -$139 million in net earnings distortion that cause earnings to be understated.

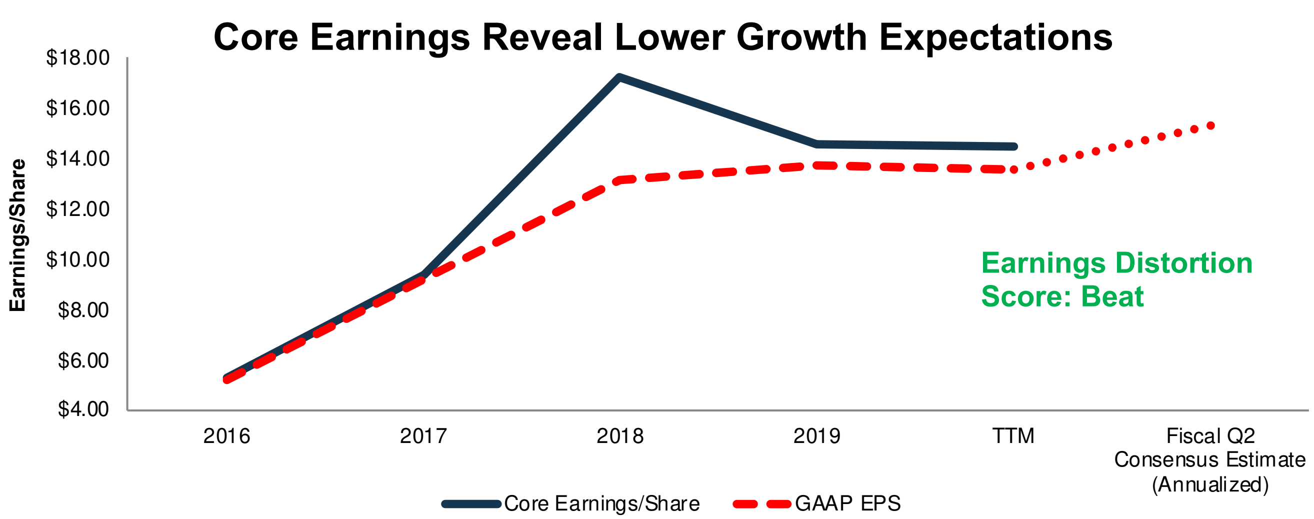
Contributing to this earnings distortion, LRCX disclosed a $64 million (<1% of assets) tax charge as a result of U.S. tax reform in its 2019 10-K.

In total, we identified $0.89/share (7% of TTM reported EPS) in earnings distortion in LRCX's TTM results. After removing this earnings distortion from GAAP net income, we see that LRCX's core earnings of $14.48/share are significantly above its GAAP EPS of $13.59.

The analyst consensus for LRCX's fiscal Q2 earnings is $3.84/share, which comes out to $15.36/share on an annualized basis. Based on GAAP earnings, current analysts' estimates imply a 13% increase in annualized earnings. Figure 2 shows that, after removing earnings distortion, consensus estimates imply a much lower increase of just 6%.

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 together, LRCX looks well set up to beat expectations.

Figure 2: LRCX Core Earnings Vs. GAAP: 2016-Fiscal Q2 2020



Sources: New Constructs, LLC and company filings

Pfizer (PFE) – Earnings Distortion Score: Strong Miss – Earnings Date: 1/28/20 before open

PFE's earnings are overstated due to earnings distortion and the stock should strongly miss earnings based on its Earnings Distortion score.

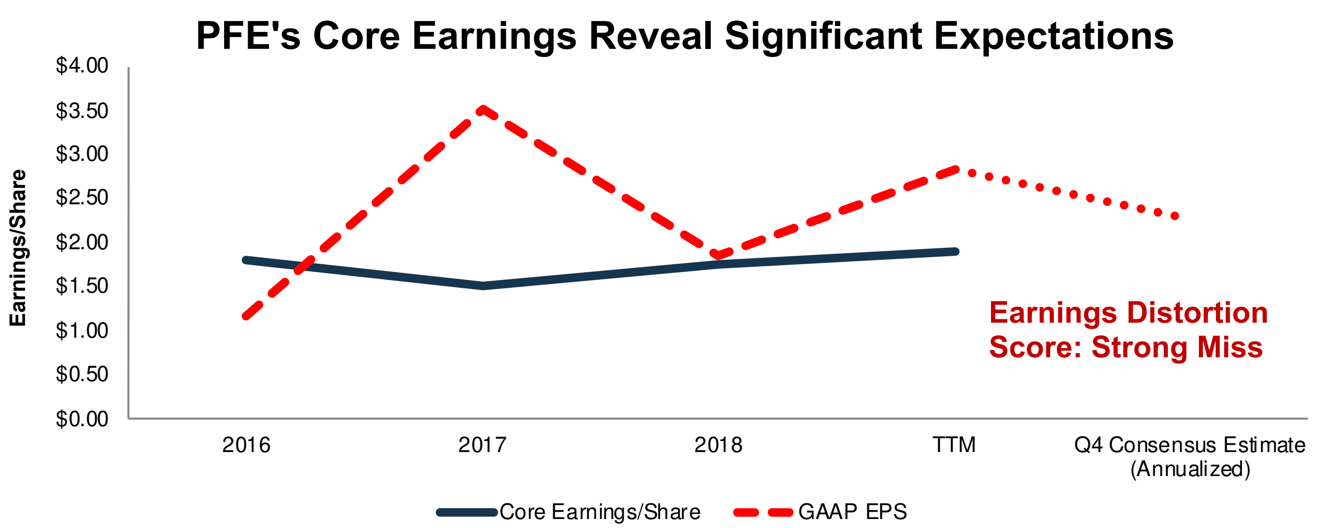
Over the trailing twelve months (TTM) period, PFE had $5.3 billion in net earnings distortion that cause earnings to be overstated. The most notable unusual income stems from an $8.1 billion gain on the completion of the Consumer Healthcare joint venture with GlaxoSmithKline (GSK), reported in 3Q19.

This unusual income was partially offset by non-recurring expenses, such as $3.1 billion in asset impairments in PFE's 2018 10-K.

In total, we identified $0.93/share (33% of TTM reported EPS) in earnings distortion in PFE's TTM results. After removing this earnings distortion from GAAP net income, we see that PFE's core earnings of $1.89/share are significantly below its GAAP EPS of $2.82.

The analyst consensus for PFE's Q4 earnings is $0.57/share, which comes out to $2.28/share on an annualized basis. Based on GAAP earnings, current analysts' estimates imply a 19% decrease in annualized earnings. Figure 3 shows that, after removing earnings distortion, consensus estimates imply a much higher and more optimistic increase of 20%.

Figure 3: PFE Core Earnings Vs. GAAP: 2016- Q4 2019



Sources: New Constructs, LLC and company filings

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

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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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