Danger Zone: Investors Who Ignore the Real Earnings Season

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life.

The financial press loves to hype up "earnings season", but corporate earnings announcements often provide misleading data as empirically demonstrated by professors at Harvard Business School & MIT Sloan.

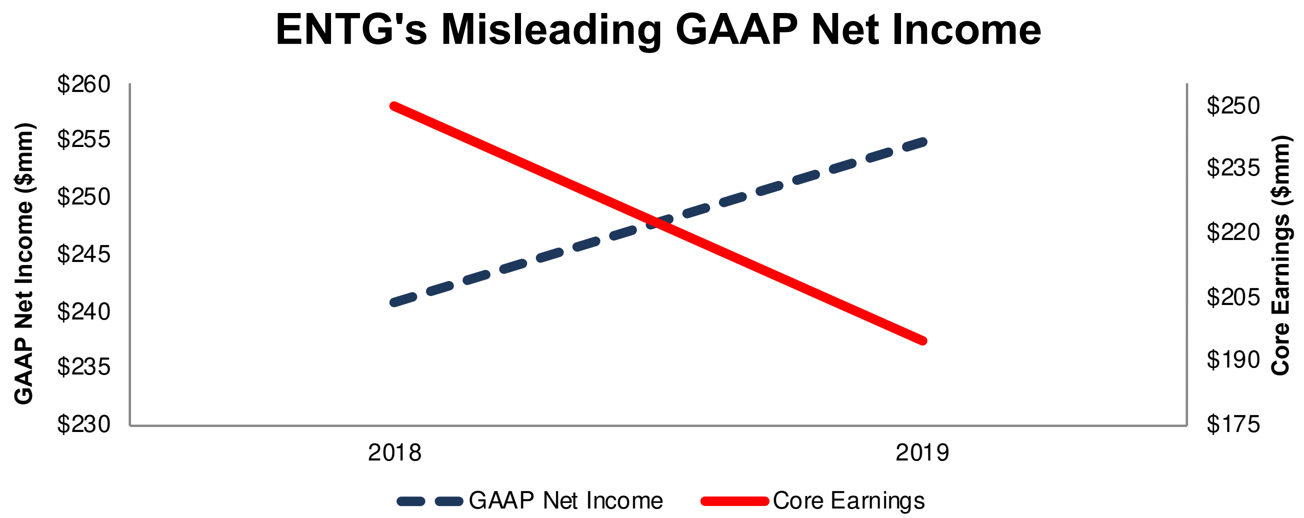
The real earnings season, 10-K filing season, is happening now. It's the time when companies publish 10-Ks or annual reports, the only filings where investors can find the financial footnotes and MD&A, which are required to get an accurate and complete measure of a firm's true profits. Two companies from the beginning of filing season have core earnings trending in the opposite direction of GAAP earnings. Entegris Inc. (ENTG: $57/share) and Power Integrations Inc. (POWI: $102/share) are in the Danger Zone this week.

Entegris Inc. (ENTG) – Very Unattractive Rating – Strong Miss Earnings Distortion Score

Entegris Inc. (ENTG) filed its 10-K with the SEC on February 7, 2020. Despite positive and rising GAAP net income, our research reveals deteriorating fundamentals.

Misleading Earnings: In 2019, GAAP net income grew by 6% year-over-year (YoY) while core earnings, a superior measure of profits[1], fell 22% per Figure 1.

Figure 1: ENTG's Misleading GAAP Net Income Hides Falling Core Earnings



Sources: New Constructs, LLC and company filings.

In 2019, ENTG had $60 million in net earnings distortion that caused earnings to be overstated. Notable unusual income in ENTG's filings include:

- $122 million in non-recurring income related to the fee Versum paid to terminate a proposed merger

This non-recurring income was partially offset by:

[1] In Core Earnings: New Data & Evidence, professors at Harvard Business School (HBS) & MIT Sloan empirically show that our "novel dataset" is superior to "Street Earnings" from Refinitiv's IBES, owned by Blackstone (BX) and Thomson Reuters (TRI), and "Income Before Special Items" from Compustat, owned by S&P Global (SPGI).

- $9 million in severance and restructuring costs included in SG&A – Page 36
- $4 million in costs associated with the acquisition of MPD – Page F-15 (Page 75 total)
- $2 million in severance and restructuring costs included in Engineering, Research & Development – Page 37

Only by removing these non-recurring gains and losses can we evaluate the core earnings of ENTG's operations. In total, we identified $0.44/share (24% of GAAP EPS) in net unusual income in ENTG's 2019 GAAP results. After removing this earnings distortion, ENTG's 2019 core earnings of $1.43/share are significantly less than GAAP EPS of $1.87.

With significantly overstated earnings, ENTG earns a "Strong Miss" Earnings Distortion Score, which means it is more likely to miss consensus expectations going forward.

We also adjust balance sheets to hold management accountable for all capital invested into a business; so we can calculate a more accurate return on invested capital (ROIC) and economic earnings, the true drivers of shareholder value.

Some notable adjustments to ENTG's 2019 balance sheet were:

- $543 million in accumulated asset write-downs, including $11 million in 2019
- $54 million in the present value of operating leases

After all adjustments, we find that ENTG's economic earnings fell 65% YoY in 2019. In addition to falling core and economic earnings, ENTG's ROIC fell from 13% in 2018 to 10% in 2019 while its net operating profit after-tax (NOPAT) margins fell from 18% to 15% over the same time.

Shares Are Now Overvalued: We believe the outperformance of ENTG (+64% vs. S&P 500 +21%) over the past year has been driven by noise traders fooled by the company's rising accounting earnings. When we remove the accounting distortions and look at the expectations implied by the stock price, ENTG appears significantly overvalued.

To justify its current price of $57/share, ENTG must achieve 18% NOPAT margins and grow NOPAT by 14% compounded annually for the next decade. See the math behind this reverse DCF scenario. An 18% NOPAT margin would equal the highest NOPAT margin in company history, compared to 15% in 2019. Markets and Markets, an industry research provider, expects the entire Semiconductor Equipment market to grow by 9% compounded annually from 2020-2025, which further highlights the optimism in this scenario.

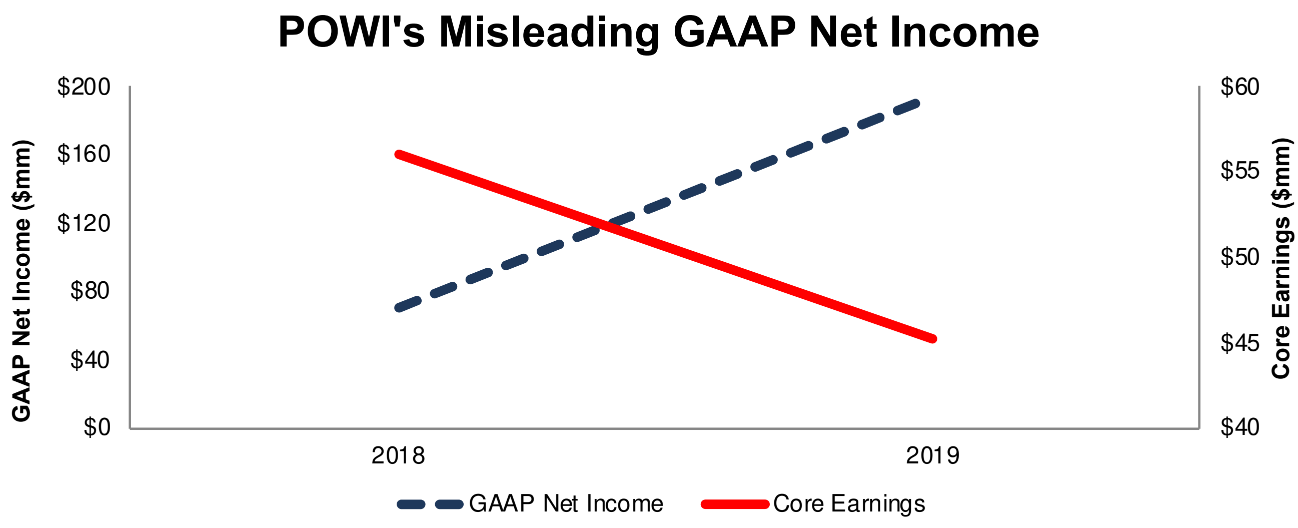
Even if ENTG can maintain current NOPAT margins (15%) and grow NOPAT by 9% compounded annually (in-line with projected industry growth rate) for the next decade, the stock is worth just $37/share today – a 34% downside. See the math behind this reverse DCF scenario.

Power Integrations Inc. (POWI) – Unattractive Rating – Strong Miss Earnings Distortion Score

Power Integrations Inc. (POWI) also filed its 10-K with the SEC on February 7, 2020. We dug through its 10-K and, despite positive and rising GAAP net income, we found its GAAP earnings overstate core earnings.

Misleading Earnings: In 2019, GAAP net income grew by 176% year-over-year (YoY) while core earnings fell 19% per Figure 2. As demonstrated in "Core Earnings: New Data and Evidence," corporate managers bury gains & losses in footnotes to help meet or beat earnings goals. POWI beat consensus EPS expectations in each of the last eight quarters. Despite these beats, the firm's core earnings have fallen in each of the past two years.

Figure 2: POWI's GAAP Net Income Rises While Core Earnings Fall



Sources: New Constructs, LLC and company filings.

In 2019, POWI had $148 million in net earnings distortion that cause GAAP earnings to be overstated. Specifically, POWI's profits were boosted by:

- $169 million litigation settlement with ON Semiconductor Corporation
- $5 million in other income consisting primarily of income earned on cash, securities, and other investments

We also identified $249,000 in non-recurring expenses related to the loss on disposal of property and equipment. While these unusual expenses may be considered immaterial by other firms, we collect them anyway because we collect all unusual expenses. Unless we collect all unusual items, we can never be completely sure that, when combined, these small unusual items add up to a material amount. Our Robo-Analyst technology allows us to do the diligence and adjust for all unusual items so our clients can trust the consistency and rigor of our models.

In total, we identified $4.97/share (77% of GAAP EPS) in net unusual income in POWI's 2019 GAAP results. After removing this earnings distortion from GAAP net income, we see that POWI's 2019 core earnings of $1.51/share are significantly less than GAAP EPS of $6.49.

With significantly overstated earnings, POWI earns a "Strong Miss" Earnings Distortion Score, which means it is more likely to miss consensus expectations going forward.

We also made adjustments to POWI's balance sheet and find that its invested capital increased 8% YoY in 2019. Meanwhile, its NOPAT fell by 21% over the same time. Not surprisingly, its ROIC fell from 15% in 2018 to 11% in 2019.

After all adjustments, we see that POWI's fundamentals are deteriorating, despite its streak of earnings beats. In addition to the declines noted above, economic earnings fell 67% YoY in 2019 and NOPAT margin dropped from 14% in 2018 to 11% in 2019.

Shares Are Overvalued: POWI has outperformed the market over the past two years (+51% vs. S&P +23%) and those using flawed traditional valuation metrics would believe POWI is still undervalued. At its current price of $102/share, POWI has a price-to-earnings (P/E) ratio of 15.7, which is well below the Technology sector's 34.8. On the other hand, POWI's price-to-core-earnings ratio of 66.6 is significantly higher than the price-to-core-earnings ratio of the Technology sector, which sits at 37.7.

Similarly, when we analyze the cash flow expectations baked into the stock price using our reverse DCF model, we see that POWI is significantly overvalued.

To justify its current price of $102/share, POWI must achieve a 15% NOPAT margin (company best in 2010, compared to 11% in 2019) and grow NOPAT by 16% compounded annually for the next 16 years. See the math behind this reverse DCF scenario. These expectations seem overly optimistic given that POWI's NOPAT has grown by half this rate (8% compounded annually) over the past decade and the Power Management Integrated Circuit market is expected to grow by just 5% compounded annually through 2024.

Even if POWI can achieve a 15% NOPAT margin and grow NOPAT by 13% compounded annually for the next decade, the stock is worth just $58/share today – a 43% downside. See the math behind this reverse DCF scenario.

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

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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.

Learn more.

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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