Improving Our Company Models: Suspended Ratings for Changes in Required Cash

We are adding a new reason for suspending Stock and Credit Ratings that relates to our calculation of Invested Capital. Specifically, we will now suspend ratings for companies that experience large changes in required cash, based on our excess cash analysis. We will also add an Analyst Note every time we change our assumption for required cash as a percentage of sales.

Brief Background

One of the numerous adjustments we make to calculate Invested Capital is to determine the amount of a company's cash that we should include or exclude in Invested Capital. We name the cash that we include in Invested Capital "required cash", while the cash we remove from Invested Capital is "excess cash". We think of required cash as the amount of cash needed for the company to run its business. Excess cash is the cash that companies do not need to operate their businesses.

For most companies, we estimate the amount of required cash to be 5% of sales. We increase the required cash as a percent of sales for companies with large operating losses, as they need more cash to fund operations. For instance, we assume a company with large enough losses needs 100% of its cash to fund its large losses and, therefore, will have no excess cash. Conversely, we decrease the required cash percentage for companies with large operating profits, which may need little to none of their cash to fund operations. This concept seems simple to apply, but, in reality, it can be quite difficult to apply in certain scenarios.

For example, when a company with large losses become profitable, our assumption for the required cash as a percent of sales will drop, which can cause large decreases in required cash and a large increase in excess cash. As a result, the company's Invested Capital might also drop by a large amount. In turn, our model would likely also show a large increase in free cash flow (FCF), over and above what the improvement in the operations of the business would suggest. In other words, lowering our assumption for required cash creates an artificial boost to free cash flow. On the other hand, when companies with large profits become unprofitable, raising our assumption for required cash creates an artificial reduction to free cash flow.

New Suspension and Analyst Note

In order to alert clients to instances where a change in required cash materially impacts our calculation of Invested Capital, and therefore FCF, return on invested capital (ROIC), and economic earnings, we added:

1. A suspension for rating for companies that experience large changes in required cash.
2. An Analyst Note for any company where we change our assumption for required cash as a % of sales.
    a. The Analyst Note will read "Required Cash Assumption Updated".
3. In the near future, we will add calculations of free cash flow that exclude the impact of cash. Stay tuned.

Specifically, we will suspend a company's rating whenever:

1. The change in required cash is greater than 50% (negative or positive) of Invested Capital and
2. There is also a change in excess cash.

After this update, 29 companies will have a newly suspended rating.

The new Analyst Note and Suspended Rating logic will be live on November 29, 2023. Read more on reasons for suspended ratings and Analyst notes here.

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Disclosure: David Trainer, Kyle Guske II, Hakan Salt, Sam Moorhead, and Italo Mendonça receive no compensation to write about any specific stock, sector, style, or theme.

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Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.

- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.

- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.

- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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