Screening for Earnings Quality

"There is no true number in accounting, and if there were, auditors would be the last to find it."

SEC Commissioner Harvey Pitt

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Earnings Quality - What?

- For the purposes of this presentation, we use the term Earnings Quality to denote how well accounting earnings represent the economic cash flows of the business.

- Obviously the first part of this analysis requires understanding the economics of the business.

- To check on how well accounting earnings reflect these economics, we can use a number of tools:

  - Compliance Focus: Do the accounts comply with the rules?

  - Comp. Compliance: Where do different rules produce different results? Comparison of different accounts (tax/management/GAAP/regulatory)

  - Fundamental DD: Anecdotal evidence versus accounts

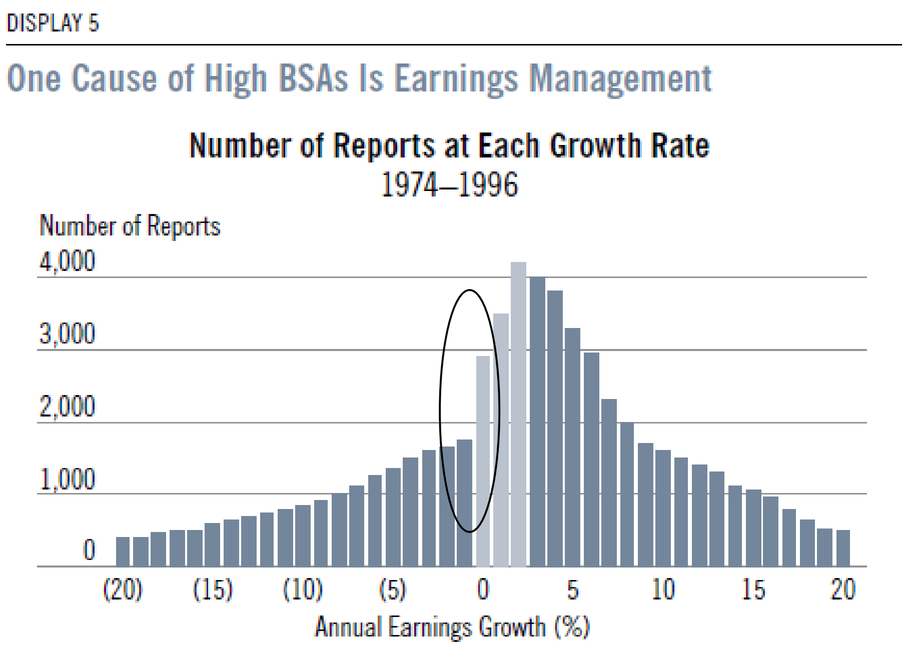
  - Accruals: Where cash flow does not equal earnings this represents subjectivity. Can approach either top down or bottom up.

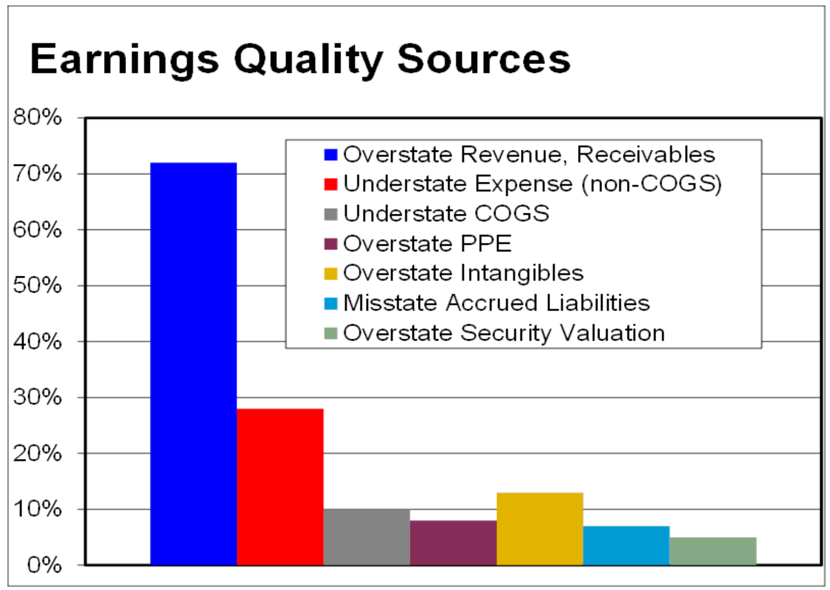
- All of these tools can be important, but our initial focus is on accounting accruals (i.e. the difference between Profit and Cash Flow).

- Because accruals are subjective, they are prone to error, both unintended and deliberate.

Earnings Quality - Why?

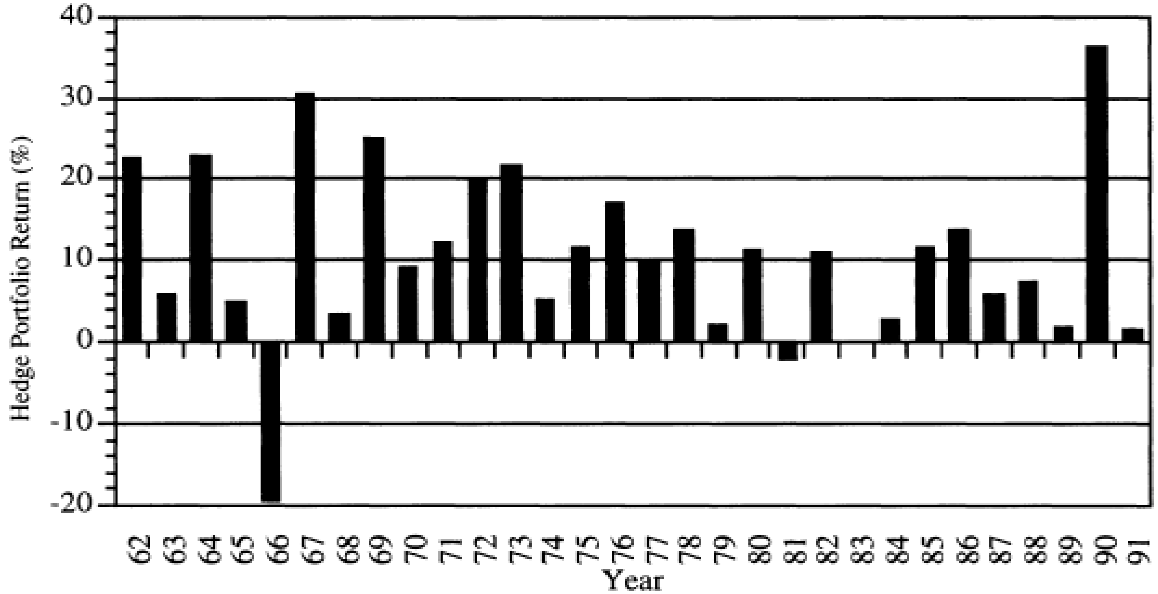
- Understanding Earnings Quality is important because…
- … we know companies manipulate earnings…
- … in a variety of ways…





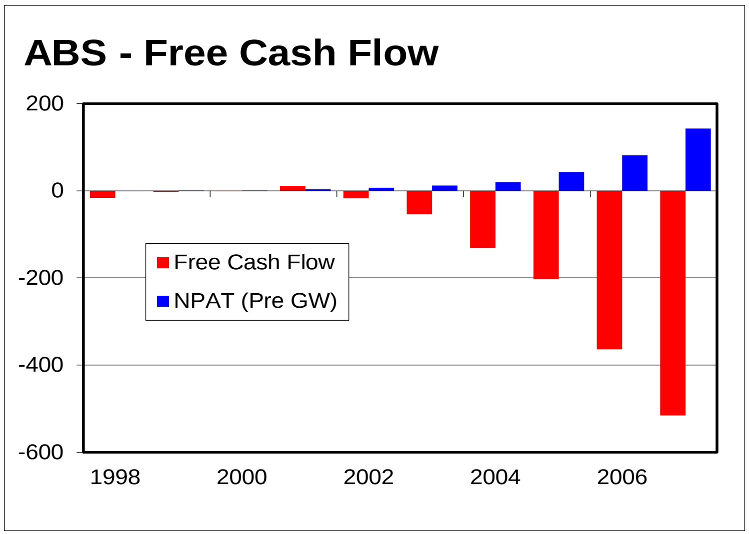
Earnings Quality – Why?

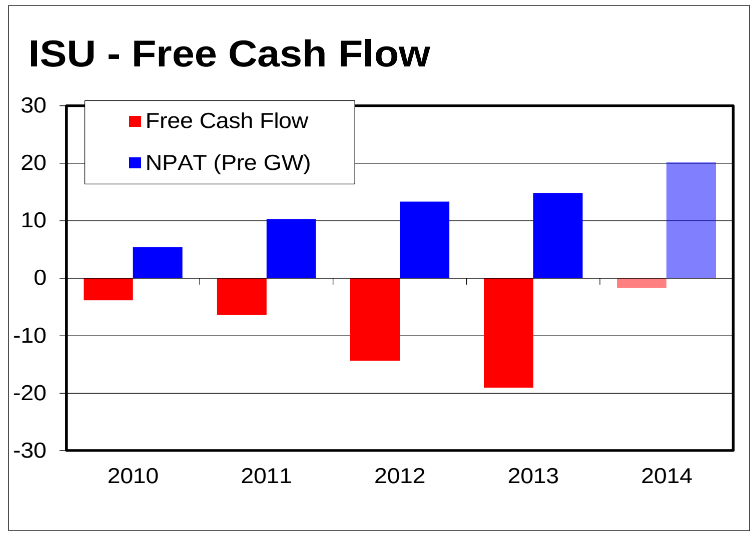
- … and we know that these differences (both deliberate and unintentional) are not efficiently reflected in share prices.
- Sloane (1996): Earnings attributable to accruals were both:
  - Less persistent than earnings attributable to cash flow.
  - Not reflected in prices
    - A hedge portfolio that was long the stocks with the lowest accruals and short the stocks with the highest accruals delivered >10% p.a. performance over 30 years with outperformance in 28/30 years.
    - Returns measured for one year from period commencing 4mths after end of financial year.
    - Accruals measured as current net operating assets, normalised by balance sheet.



Earnings Quality – Why

- The academic literature on Accruals tells us that <u>on average</u> high accruals are bad for investment performance.
- Investment experience tells us that less cash flow = more risk.

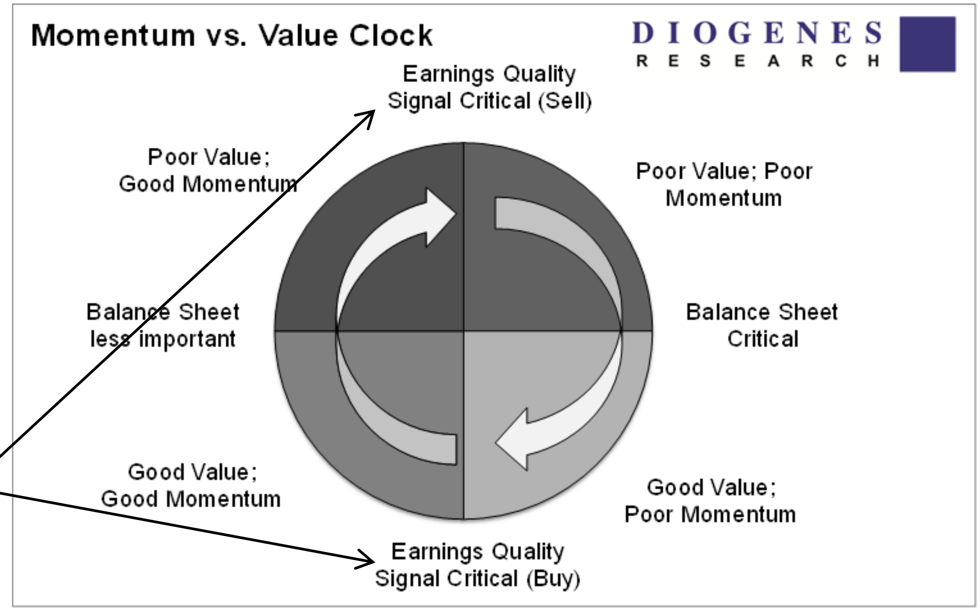




- Although the excess returns available from a simple application of the Sloan accruals approach have diminished overtime, it remains an important signal in our screening process.

Earnings Quality – How?

- Understanding the difference between accounting earnings and economic cash flow offers three potential insights:
  - Level of earnings quality is a key indicator of fundamental value
  - Change in earnings quality may provide momentum indicators
  - Nature of earnings quality may provide risk indicators.
- Therefore, like all screening factors, it must be used in context:
- … it is good for helping pick changes in earnings momentum;
- … but can be offset by valuation and/or balance sheet extremes.



The Accruals Approach

- Accruals defined as earnings residual:

  <u>Earnings = Cash Flow + Accruals</u>

- Can be measured either via the change in balance sheet or as earnings less cash.

- Can be viewed top down (total accrual) or bottom up (decompose into variables), focusing on the following issues:

  - Are operating earnings reflected in operating cash flow?

    a. What part of the differential is determined by working capital?

    b. What part of the differential is determined by other factors?

  - What is the relationship between capex and depreciation?

P&L	Cash Flow
Sales	Receipts
	- Payments
- COGS	= Gross Operating Cash Flow
- SG&A	- Interest
= EBIT	- Tax
	= Net Operating Cash Flows
EBITDA	- Capex
- D&A	- Asset Sales
= EBIT	- Acquisitions/Investments
	= Net Investing Cash Flows
- Interest	+ Share Issues
- Tax	- Dividends
= NPAT	= Net Payments to S/holders
	= Change in Net Debt

Cash Flow – Operating Cash Flow

Earnings	- Adjustments	= Cash Flow
Sales	ΔReceivables + Δ Other non-cash	Cash Receipts
"Cash" Expenses	ΔPayables + ΔInventory + ΔOther non cash	Cash Payments
EBITDA	ΔWorking Capital + Δ Other non-cash	Gross Operating Cash Flow

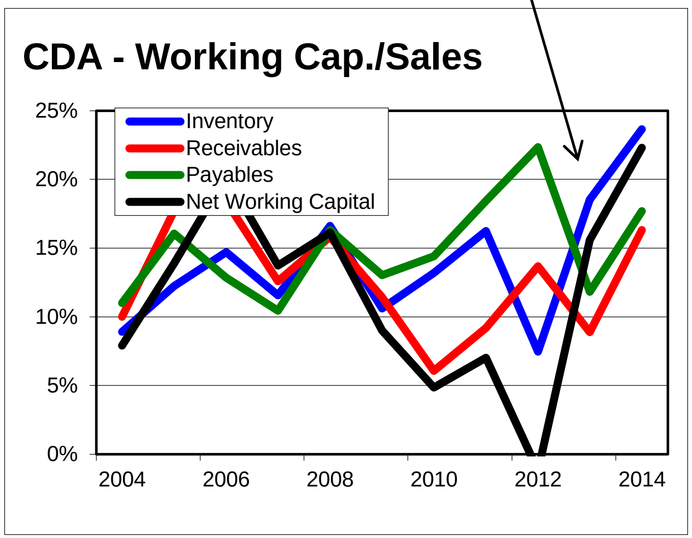
- Different drivers of operating cash flow require different questions to be asked, so we need to know what is driving operating cash conversion.

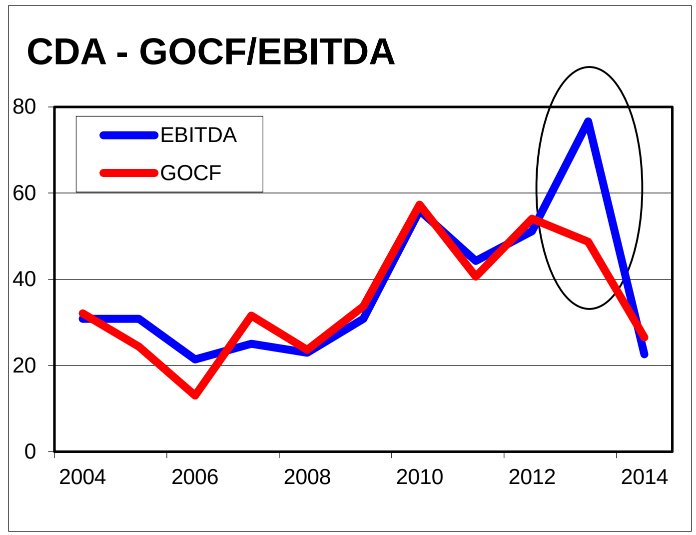
Operating Cash Flow - Working Capital (Inventory)

- Whilst working capital volatility is common, it always pays to be suspicious of changes in working capital.

- This can come via higher inventories…

- … signalling a slowdown in earnings.



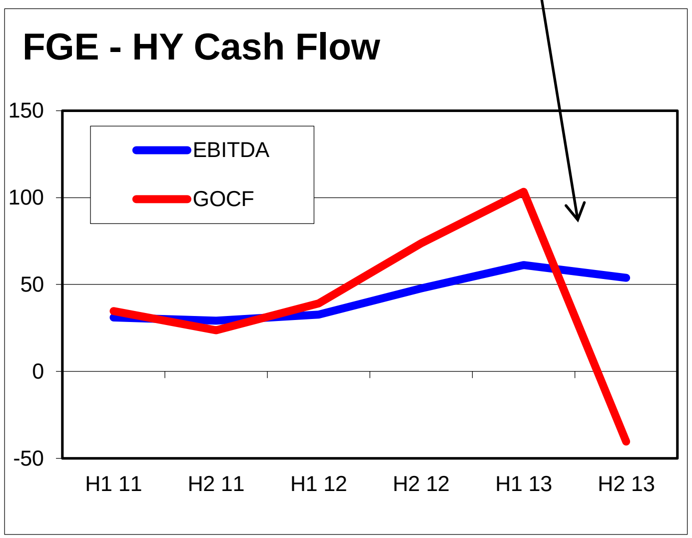


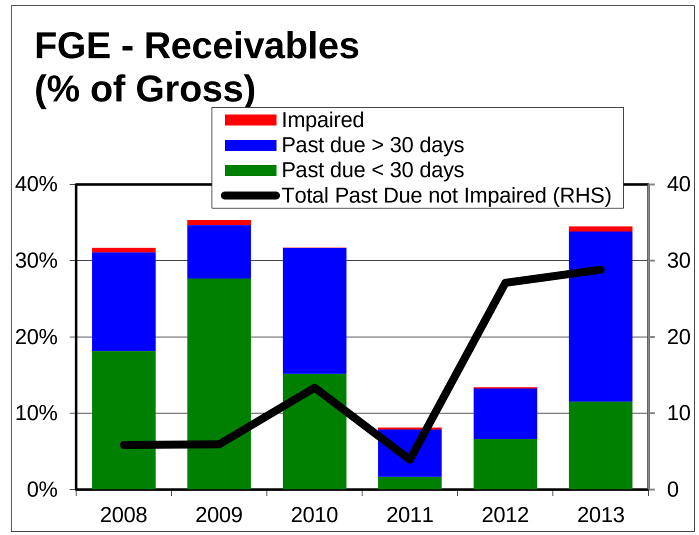
Operating Cash Flow - Working Capital (Receivables)

- Similar trends can occur where higher receivables are indicative of problems.

- Both the step up in receivables…

- … and the composition.



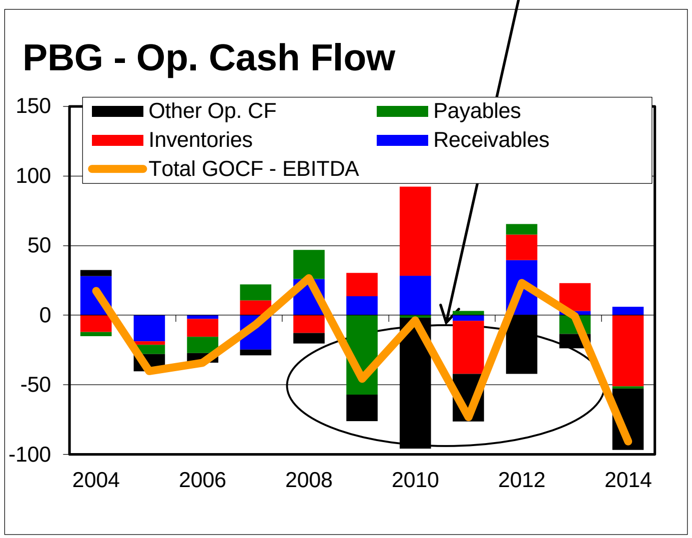


Operating Cash Flow – Other Cash Flow Items

- Cash flow shortfalls from other factors, provision utilisation, remediation and restructuring costs etc, are common.

- These can be indicative of structural problems in the business…

- … or the aggressive use of acquisition accounting.



UGL - DTZ Acquisition

$m	Dec-11	Adj.	Jun-12	Adj.	Dec-12
Tang. Assets & WC	132	-8	124	0	125
Goodwill/Intangibles	161	61	222	61	283
Provisions	-43	-37	-80	-61	-141
Employee Benefits	-59	-13	-72	0	-72
Other Liabilities	-44	-3	-47	0	-47
Total	**148**	**0**	**148**	**0**	**148**
Prov/Sales (ex. employ.)	**9%**		**17%**		**30%**

Source: Company data

- Such provisions can prop up earnings for a while, but ultimately either need to be topped up via further NRI's, or reflected in lower underlying margins.

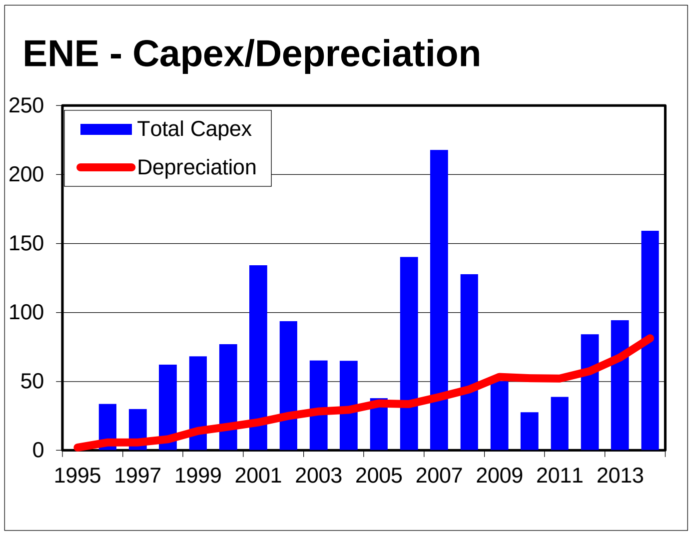
Capex v. Depreciation

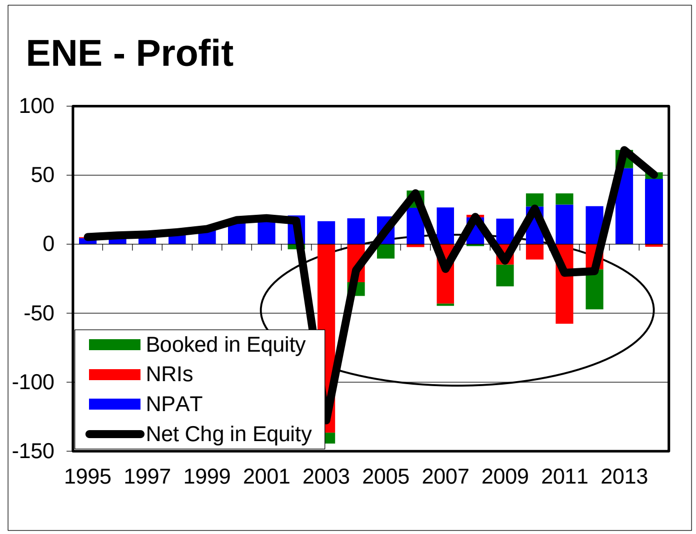
- The second major element of the cash flow statement to consider is the relationship between capex and depreciation.
- Capitalising expenses creates numerous distortions
  - Depreciation is based on historical cost.
  - Depreciation schedule may not reflect economic life.
  - Should it have been capitalised at all?
- As a result, earnings are mostly over-stated as companies serially under-depreciate. This is reflected in periodic asset write downs.
- Therefore, companies with high capex carry higher accounting risks than companies with low capex.
- In determining an appropriate depreciation amount the key consideration is what is appropriate maintenance capex? For example, Warren Buffett defines owner earnings:

> *"these represent (a) reported earnings plus (b) depreciation, depletion, amortization, and certain other non-cash charges…less (c) the average annual amount of **capitalized expenditures** for plant and equipment, etc. that the business requires **to fully maintain its long term competitive position and its unit volume."***

High Capex

- The two major issues are whether the high capital intensity of the business means
- …companies inadvertently understate true depreciation
- ….leading to subsequent write offs.



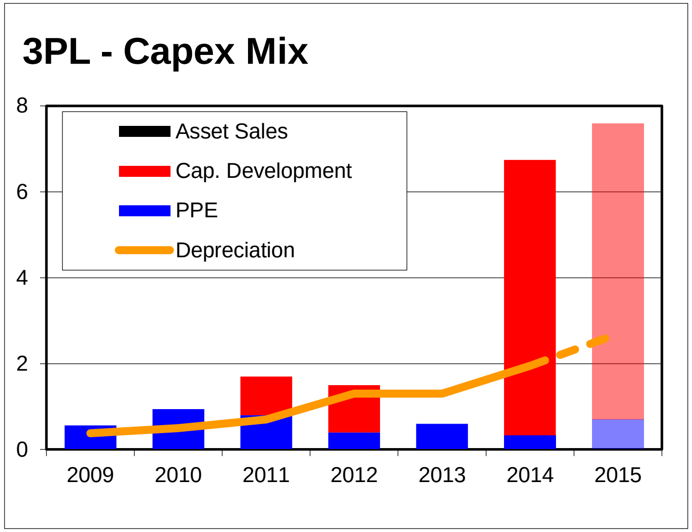


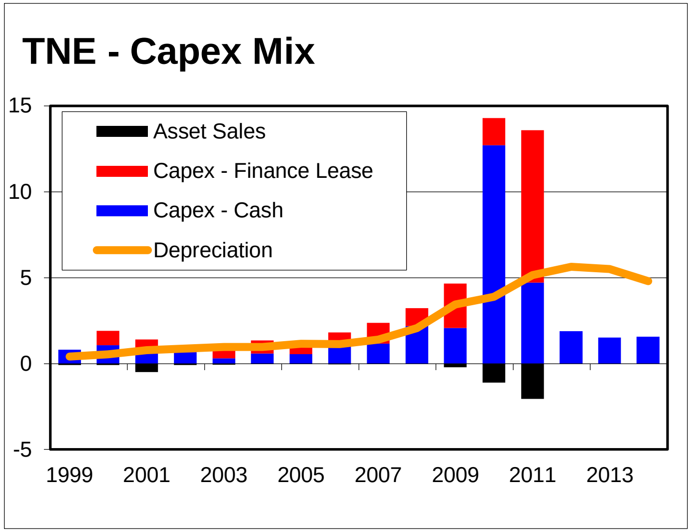
Capex v Opex

- Or whether, companies chose to treat certain opex as capex. Sometimes there is no right or wrong answer to the appropriate treatment, but…

- …we can identify changes in the treatment of expenditure..

- … and differentiate between companies.

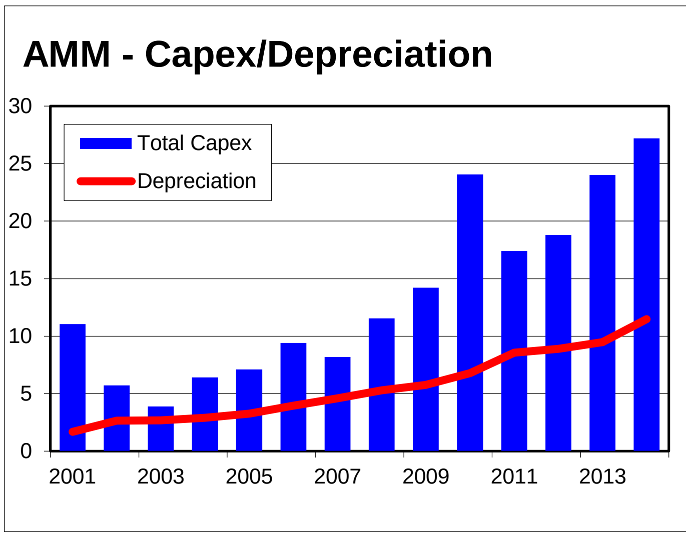


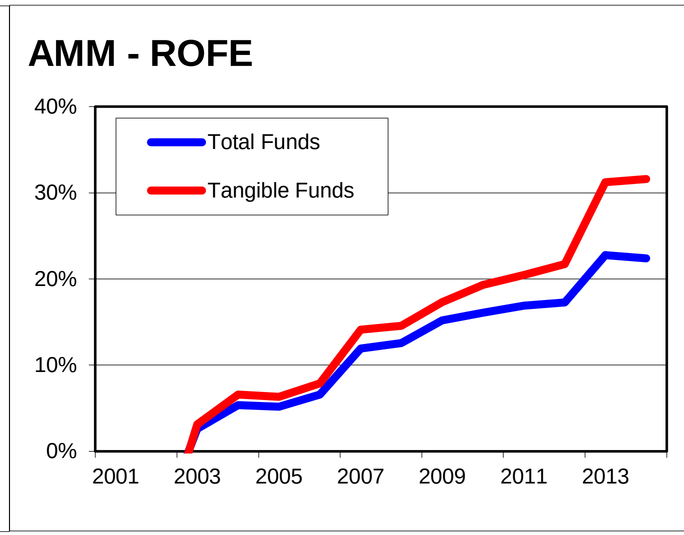


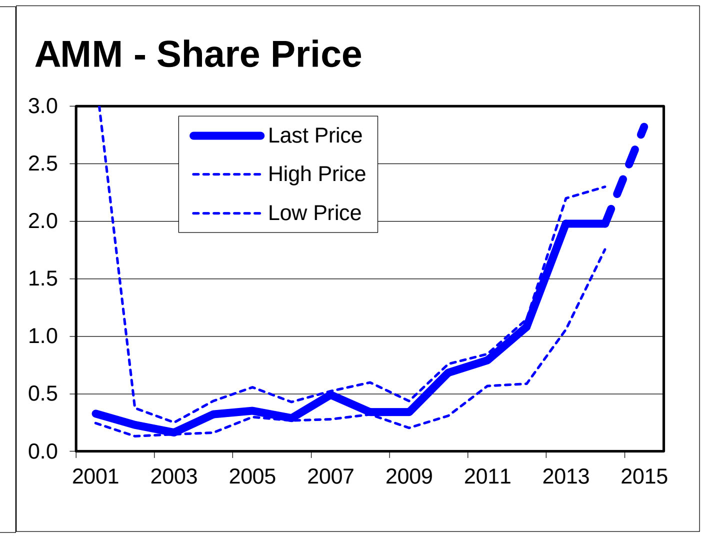
Is there Good Capex?

- The key to determining whether capex is justified, is understanding the incremental returns. Where these are positive, capex can be viewed as positive. For Example at Amcom:

- Consistent investment… … at high rates of return… … created significant value.

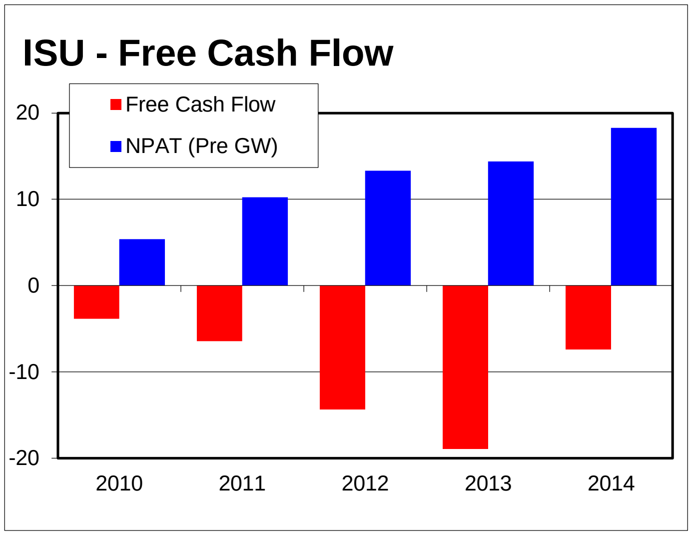






Earnings Quality - Summary

- The golden rule:
  - Less Cash = More Risk



But often the devil is in the detail:

- What is the cause of cash shortfall:
  - ➢ Working Capital
  - ➢ Other operating
  - ➢ Capex
- What are the implications for:
  - ➢ Valuation
  - ➢ Earnings Momentum
  - ➢ Risk

“To a man with a hammer, everything looks like a nail”

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