Americas CIO View

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GAAP vs. Non-GAAP EPS and Net Margins: Interpret carefully

S&P 500 net margin sets new record high in 2018 on the corporate-tax-rate cut

The S&P 500 non-generally-accepted-accounting-principles (GAAP) net income margin set a new record high of 12% in 2018, up from nearly 11% in 2017. The U.S. corporate-tax-rate cut boosted the S&P 500 net margin by about 125 basis points (bps). The 2018 S&P 500 GAAP net margin also set a record, but 2018 fourth-quarter GAAP net margin was down year-over-year as GAAP earnings were 68% of non-GAAP vs. 78% in the fourth quarter of 2017. This was despite many charges were excluded from non-GAAP earnings in the fourth quarter of 2017 related to new deferred tax liabilities from the deemed repatriation tax. One time charges are generally seasonal and cyclical, i.e. higher in fourth quarter vs. other quarters and high in recessions. But the large GAAP vs. non-GAAP spread in the fourth quarter of 2018 is from several large idiosyncratic charges that do not reflect current economic conditions.

The deemed repatriation tax created a new deferred tax liability at many multinational companies that will be paid down over the next eight years, interest free, with 8% due in each of the first five years, 15% in year six, 20% in year seven, and 25% in year eight. This will reduce cash flow from operations versus net income in future years.

Profit margins are cyclical, but not mean reverting nor a leading indicator

The 5-, 10-, 15- and 20-year average non-GAAP net margins for the S&P 500 are 10.7%, 9.9%, 9.2% and 8.7%, respectively. History shows that S&P 500 net margins are not mean reverting[1], but S&P 500 net margins are cyclical. When the next recession comes S&P 500 margins will contract. Margin compression however is not a leading economic indicator and when margin contraction begins it is not destined to continue to the magnitude that occurs in recessions or cause a recession. This long cycle has already twice demonstrated, in 2012 and 2016, that quarterly net margins, especially GAAP net margins, can contract and then rebound to new highs within a cycle. This also occurred in 1985 and 1998.

Be mindful of the gap between GAAP and non-GAAP EPS and net margins

GAAP earnings per share (EPS) includes all items but discontinued operations and the cumulative effect of accounting changes. Non-GAAP EPS generally excludes asset impairments and usually gains and losses on asset sales (at non-financials) and often other lumpy items like large restructuring, tax or litigation charges. We think true EPS sits in-between GAAP and non-GAAP EPS; and we make

In a nutshell

- S&P 500 net margin sets new record high in 2018 on the corporate-tax-rate cut
- Profit margins are cyclical, but not mean reverting nor a leading indicator
- Be mindful of the gap between GAAP and non-GAAP EPS and net margins
- GAAP/non-GAAP ratio lower since 2015, but cycle average in line with history
- Comparing cash flow to non-GAAP net income

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[1] Mean reversion is the assumption that a variable's value will tend to move to the average value over time.

adjustments for such in our valuation process. Complexities exist in assessing fair inclusions or exclusions from non-GAAP earnings and the economic meaning of the differences. For instance, companies write down assets when the market value is lower than book value, but do not write them up if the market value is higher. Restructuring charges or litigation can be large and distort current period performance. In our opinion, non-GAAP EPS helps to evaluate current performance, but over time it overstates true EPS, yet GAAP understates true EPS.

GAAP/non-GAAP ratio lower since 2015, but cycle average in line with history

The average GAAP/non-GAAP S&P 500 EPS ratio since 1990 is 80%, and 86% out of recessions. For this cycle, the average ratio is 90.3% in the early years 2010 to 2014, but declined to 81.8% during 2015 to 2018, which can be mostly attributed to asset sale losses and impairments during the 2015 to 2016 oil-price collapse, and some idiosyncratic goodwill impairments and asset write-downs in the last couple of years. The Energy sector's GAAP/non-GAAP ratio plummeted during the oil collapse, Materials and Industrials also saw their ratios decline. The Health-Care sector also saw its ratio decline on goodwill impairment and acquisition related expenses.

Comparing cash flow to non-GAAP net income

In addition to comparing GAAP to non-GAAP earnings, we compare earnings to adjusted cash flow. One of the adjusted measures we consider is: (Net Income + D&A) / (CFO-stock-option expense). We subtract stock option expense from Cash Flow from Operations (CFO) and add Depreciation and Amortization[2] (D&A) to Net Income. Stock option grants do not reduce aggregate free cash flow, but do reduce expected future free cash flow per share. We add D&A to net income, to reverse the provision for maintenance capital expenditure (capex), to better compare net income to gross cash flow before investment. Adequacy of capital expenditures for maintenance and the expected returns on investment capex must be considered separately. We make this comparison on a multiyear rolling basis because there are many timing differences between accounting provisions and cash payments, such as with taxes and pensions. Over the past few years, (non-GAAP Net Income + D&A) has been 5 to 15% higher than (CFO-option expense) vs. ~5% before that. Thus, non-GAAP earnings appear to be overstating cash generation lately vs. earlier this cycle.

[2]Amortization is the practice of spreading an intangible asset's cost over multiple periods.

Glossary

Basis point

One **basis point** equals 1/100 of a percentage point.

Book value

Net value of a company's physical and intangible assets

Capital expenditures (capex)

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Depreciation

In relation to currencies, depreciation refers to a loss of value against another currency over time.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Generally accepted accounting principles (GAAP)

Generally accepted accounting principles, or **GAAP**, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

Idiosyncratic risk

Idiosyncratic risk is a risk which is related solely to the individual company and has no correlation with the general market risk.

Margin

Margin describes borrowed money that is used to purchase securities.

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Valuation

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm’s stock price in relation to its earnings.

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