HIDING IN PLAIN SIGHT: PRO FORMA FINANCIAL METRICS IN THE POST-TRUTH AGE

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Where To Look

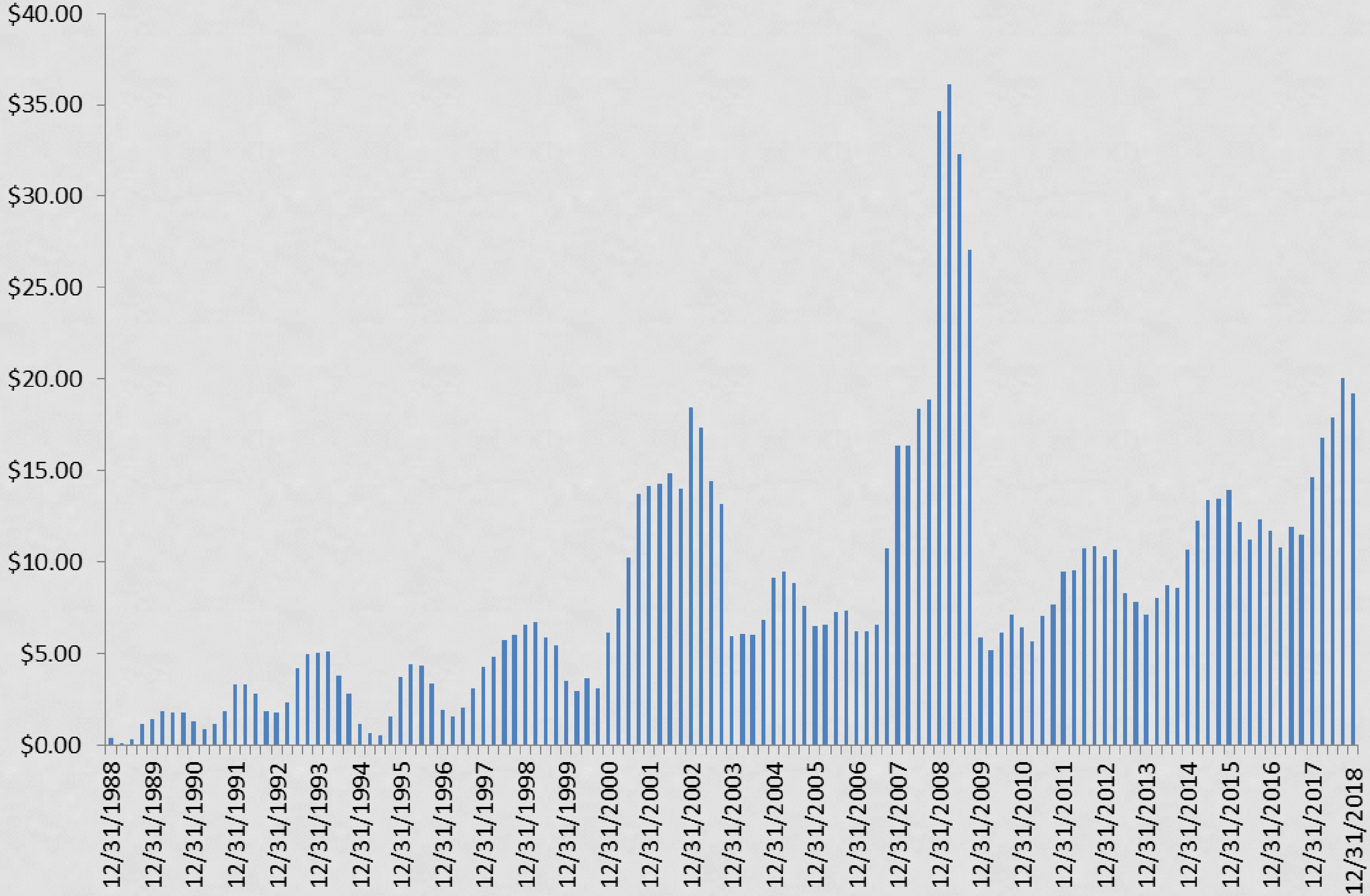
- Quarterly and annual reports ‘filed’ with the SEC are a treasure trove of information
  - Financial reporting is tightly regulated
- Earnings press releases are ‘furnished’ with the SEC
  - Lightly regulated
  - ‘Wild West’ compared with official SEC filings
- Financial statements are prepared by management, not outside auditors
- Companies that direct you to non-GAAP financials are telling to you to ‘pay no attention to the man behind the curtain’
- Don’t expect auditors to uncover fraud
  - No auditor has uncovered a case of major financial fraud in the last twenty-five years!
- Companies are increasingly getting the benefit of the doubt on non-GAAP accounting

Late 1990s Vs. Present Day

1990s	Present Day
• Self-defined accounting metrics become prevalent in corporate earnings releases – 12% of non-GAAP EPS ‘beats’ were $0.05-0.15 above consensus	• ~90% of S&P500 companies use at least one non-GAAP measure in earnings releases – 26% of non-GAAP EPS ‘beats’ were $0.05-0.15 above consensus
• Profitless companies turn to non-GAAP metrics to burnish results and justify valuations – ‘Eyeballs’, clicks – All about revenue growth	• Profitless companies turn to non-GAAP metrics to burnish results and justify valuations – TAM – All about revenue growth
• Dot-com craze and IPO bubble	• Unicorns, Cryptomania, and FAANG

Source: “Study: Earnings surprises are bigger, thanks to growing use of non-GAAP metrics”, MarketWatch, August 11, 2018; Bloomberg

S&P 500 Delta In Operating EPS Vs. GAAP EPS (LTM)



Source: S&P Global

[Non]-Recurring Restructuring Charges

- Be wary of companies that take restructuring charges every year and add them back to earnings
- Restructuring charges can mask, and usually are, real operating expenses
- Kellogg has taken restructuring charges every year for over a decade
- Caterpillar has taken restructuring charges every year since 2011
- Alcoa took “one-time” restructuring charges every quarter between 1Q11 and 3Q16 before splitting the company in two
  - Restructuring charges continued post split, and the spin-off, Arconic, was split into two companies in February 2019

Source: Company Filings

Stock-Based Compensation

- Stock-based compensation (SBC) should not be added back to earnings
- Adjusted financials with SBC added back are increasingly becoming the norm in Silicon Valley
  - TSLA's combined 3Q18 and 4Q18 GAAP EPS of $2.56 nearly doubled to $4.90 when adding back SBC
  - 67% of Salesforce's FY20 non-GAAP EPS guidance of $2.74-2.76 is in the form of SBC, up from 60% of FY19 EPS
- Stock issuance is a real expense that dilutes shareholders
  - Shares could have been issued to raise capital, but were instead used to pay labor and management
  - Just because this expense is non-cash does not mean it isn't real

Source: Company Filings

Executive Compensation

- Studies show executive compensation tied to non-GAAP earnings results in higher executive pay
  - Management is rewarded for steering the company on dubious metrics
- Proxy statements filed with the SEC should tell you how management gets paid
  - Performance metrics and short-term incentives are key indicators
  - ‘Follow the money’
- Compensation tied to non-GAAP metrics does not align with maximizing shareholder value
  - US exploration & production executives are often paid on production growth, and rarely on economic returns

Source: “High Non-GAAP Earnings Predict Abnormally High CEO Pay”, Nicholas Guest, S.P. Kothari, and Robert Pozen, January 2019

Insider Selling And Buybacks

- SEC Commissioner Robert Jackson warns that insiders are selling stock to cash out while their companies are buying back shares
  - SEC study finds increase in insider sales immediately following buyback announcements
  - Even worse, the companies studied underperformed peers by (8%)
  - Insiders putting their own financial interests ahead of their shareholders
- Buyback programs frequently used to reduce the share float to flatter EPS
- Politicians seeking legislation that would limit insider selling within a certain timeframe of buyback announcements
- What do buybacks signal?
  - Bulls might say ‘the stock is cheap’
  - Bears might say ‘management is indicating that investing in growth is unattractive’

Source: Bloomberg

Legal Fraud

VRX: Valeant Pharmaceuticals

- VRX was a debt-fueled roll-up whose business model was acquiring companies, raising prices, and slashing R&D expenses
- Arguably the largest source of losses in hedge fund history as stock fell from $260 in July 2015 to $15 by YE16 and market cap shrunk by $80B
- Management steered Wall Street towards adj. EBITDA and “cash EPS”
  - Gave FY15 “cash EPS” guidance of $11.50-11.80 on 2Q15 earnings
  - GAAP EPS for FY15 was negative $(0.85)
- Wall Street knew all about pro forma accounting games
  - Adj. EBITDA and cash EPS added back amortization of drug patents with limited useful lives
  - Cash EPS and adj. EBITDA failed to capture the long-term costs of replacing the drug pipeline
- Earnings release overstates FY16 adj. EBITDA guidance by $200-600M
  - Guidance issued just weeks after embattled CEO Mike Pearson returned from mysterious medical leave amidst questions about distribution unit, Philidor
  - 4Q15 call had already been postponed several weeks, and the company still couldn’t get its numbers right

Source: Company Filings, CNBC, Bloomberg

VRX: Philidor Fraud

- R&O Pharmacy challenged Valent invoices for $70M
  - R&O had not done any direct business with VRX at the time
- R&O was conducting its business through Philidor Rx Services
  - Philidor is a ‘specialty pharmacy’, filling, shipping, and getting insurance approval for prescriptions of the more complex drugs VRX made
- VRX never disclosed any financial connection between itself and R&O
- VRX lent money to Philidor’s ownership group and eventually announced that its equity stakes in Philidor are potentially collateral
- At least 90% of Philidor’s revenue came from sales of VRX drugs
- “Valeant maintained a network of ‘ghost ship’ pharmacies designed to buy product that no one had actually ordered, a form of fraud known as channel stuffing”
- Philidor’s existence was to secure insurer reimbursement for VRX drugs
  - In some instances, Philidor resubmitted claims using the billing identification number of other affiliated pharmacies until an insurer approved payment

Source: “A Valeant Boo-Boo May Portend Bigger Errors”, New York Times, April 1, 2016; Reuters; Southern Investigative Reporting Foundation

DJT: Trump Hotels & Casino

- SEC brings first enforcement action over fraudulent pro forma financial reporting against Trump Hotels & Casino Resorts in January 2002
- DJT said it “beat” 3Q99 earnings estimates excluding one-time charge, but failed to disclose that it included large, one-time gain in net income
  - “Had the one-time gain been excluded from the quarterly pro forma results as well as the one-time charge, those results would have reflected a decline in revenues and net income and would have failed to meet analysts' expectations”
  - “The undisclosed one-time gain was thus material, because it represented the difference between positive trends in revenues and earnings and negative trends in revenues and earnings, and the difference between exceeding analysts' expectations and falling short of them”
- SEC found Trump Hotels violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder (scienter-based fraud)
  - Company was ordered to “cease and desist from violating those provisions”
- November 2004: Trump Hotels files for Chapter 11 bankruptcy protection
  - “I don’t think it’s a failure, it’s a success” – Donald Trump referring to bankruptcy
  - “In this case, it was just something that worked better than other alternatives”

Source: SEC, NBC News

Not Just In The USA: Alibaba

- BABA shifts losses to unconsolidated affiliates, which are reflected in the P&L as “share of results of equity investees” below the EBIT line
  - Adjusted earnings metrics exclude SBC, share of results of equity investees, and other items “which [BABA does] not believe are reflective of our core operating performance”
- Only publishes a full cash flow statement in annual reports
- Booking valuation gains by making investments in entities that BABA had previously invested in at lower valuations
- Inflated carrying amounts for asset values
  - Carrying value of 49% stake in Alibaba Pictures (1060 HK) was increased to RMB 29.6B from RMB 4.8B, even though actual market value of stake in publicly-listed company was only RMB 10.2B
  - BABA booked at RMB 24.7B valuation gain when then initially wrote up the carrying value
- Founder Jack Ma and Co-Founder Joe Tsai launched 10b5-1 insider selling plans that would allow them to divest 14% of their combined stake by April 2020

Source: Company Filings

Not Just In The USA: SoftBank

- Vision Fund books valuation gains on investments when investing in start-ups after their initial funding
  - Paid ~13x prior valuation for robot pizza delivery truck company Zume
- Invested >$175B into 374 companies across 524 deals since 2008
- Fueling crazy Silicon Valley valuations…as long as the capital is there
  - Saudi Arabia and Abu Dhabi investment account for ~66% of $100B Vision Fund
  - SoftBank itself contributed $15B to the Vision Fund, sourcing the funds with debt
- Vision Fund has unrecognized liability from preferred dividends
  - Saudi Arabia's initial $45B investment was structured as preferred capital at a 7% yield
  - Vision Fund is loaded with negative cash flow businesses, so SoftBank is effectively on the hook
  - Preferred dividend liability reduces SoftBank's ability to make its own return
  - Management has indicated SoftBank will fund preferred dividends with asset sales and fresh capital raises…sound familiar?
- Enigmatic founder Masayoshi Son's high-leverage unicorn investment strategy is a facsimile of SoftBank in 1999, shortly before the stock fell (99%) when the dot-com bubble burst

Source: WSJ, Bloomberg

Greatest “Adjusted” Hits

- Black Box Corp.’s “Adjusted EBITDA (as adjusted)”
- WeWork’s “Community Adjusted EBITDA”
  - Adds back “growth investments” like SBC, sales & marketing, general & administrative, and development and design costs
  - FY17 “Community adj. EBITDA” margin of 27% vs. (22%) on adj. EBITDA
- Aleris’ “further adjusted EBITDA” and “structuring adjusted EBITDA”
  - Adds back metal price lag, derivatives, restructuring charges, FX moves, losses on debt, and SBC…just for regular ‘adjusted EBITDA’
  - “Further adjusted” adds back plant transition costs, while “structuring adjusted” also adds EBITDA for customers’ future purchases
  - Reported adjusted EBITDA for FY18 of $116M vs. “further adjusted EBITDA” of $239M and “structuring adjusted EBITDA” of $334M
- Lyft’s “Contribution Margin” is gross profit with amortization of intangibles, SBC, and changes to insurance reserves added back
- “I’m 5’8” but I change the scale and make myself 6’2” on a pro forma basis…I can make adjustments like standing on a box”

Source: “Bain Boss Warns Over Private Equity Debt Levels”, Financial Times, March 31, 2019; Axios, Financial Times

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