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Pulling Back the Curtain on Earnings Quality

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Year to date, traditional measures of quality such as low debt to equity and high return on equity have not been working as stock selection criteria. In fact, "quality" according to these metrics has been a headwind for much of the post-recession period. Quality is a core component of the investing process at Smith Group, yet we have a different definition of quality (see "Quality Considerations", May 2013). Our research has shown that reasonably valued companies that can sustainably grow earnings faster than expected will have strong price appreciation. A key step in our search for that unexpected growth is to ascertain the strength and sustainability of earnings. These are features that are encapsulated in our Earnings Quality model.

When evaluating the quality of earnings, it is important to view the financial statements as an integrated whole (i.e., balance sheet, income statement, and statement of cash flows). So for example, not only should changes in accruals (balance sheet) be analyzed, but also how efficiently the company is utilizing its assets (income statement and balance sheet) and how adept the company is at generating cash flow in excess of reported earnings (cash flow statement and income statement). This integrated view helps to identify sources of unexpected growth and on the flip side to identify potential weaknesses that may hinder future earnings growth.

This article looks at Earnings Quality (EQ) at a more granular level, through the lens of the Smith Group model. For this purpose we've selected two companies from the same sector, one with high or "good" EQ and one with low or "bad" EQ. The time period used for this analysis is 2012. The high EQ example is Hanesbrands, an apparel manufacturer and marketer, while the low EQ example is Family Dollar, a discount retailer. During 2012, Hanesbrands saw margins expand through supply chain improvements and pricing, plus positives such as the launch in Macy's and increased shelf space at Wal-Mart. The company was generating a FCF yield of around 10%. Over this same period, Family Dollar suffered as its price sensitive customers continued to rein in discretionary spending, and efforts to sell more discretionary goods had fallen flat. Gross margins were compressed as the company made deeper and deeper cuts to prices.

Exhibit 1 compares the two companies on an accruals focused measure, specifically the change in Net Operating Working Capital. This metric looks at how well a company is managing its current operating assets to generate cash flow. A build

Exhibit #1: Comparison of Net Operating Working Capital for a high EQ vs. low EQ company

	High EQ example			*Low EQ example*		
	Hanesbrands (HBI)			Family Dollar (FDO)		
($ millions)	ye 2012	ye 2011	Incr (decr)	ye 2012	ye 2011	Incr (decr)
+ Accounts Receivable	506	471	36	-	7	(7)
+ Inventory	1,253	1,608	(354)	1,592	1,302	290
- Accounts Payable	404	452	(48)	752	719	33
= Chg in Net Operating Working Capital			(271)			250

up in inventory, for example, may indicate a problem with obsolescence, or an increase in receivables may signal slowing collections.

Exhibit 2 compares the two companies on a measure focused on asset efficiency, specifically Asset Turnover. This is a gauge of the company's skill in investing capital.

(Continued on Page 2)

Earnings Quality

(Continued from Page 1)

Exhibit 3 shows a comparison of the two companies on a cash flow focused measure, Earnings Shortfall. This metric looks at how closely the reported earnings reflect the underlying operating cash flows a company is generating. The high EQ company is producing a significant earnings surplus, while the low EQ company is running a shortfall. An earnings shortfall may be a signal that the company is stretching to attain earnings growth and that those gains are likely to be short-lived.

The raw results from these measures are normalized (using a divisor such as Total Assets or Enterprise Value) for ranking purposes. It is important to know that the scores relate to a point in time, so a company is not labelled as "good" or "bad" indefinitely. Changes in scores flag a potentially improving or weakening financial picture.

In this comparison, the positive Earnings Quality metrics of Hanesbrands (HBI) would increase our confidence in the sustainability of positive momentum in earnings growth, while negative metrics would make us suspect management at Family Dollar (FDO) would struggle to make their numbers. Falling inventories at HBI means the refresh rate is positive, while rising inventory indicates FDO may be having difficulty clearing their shelves. Increasing asset turnover at HBI means they are improving efficiency, while a decline in asset turnover for FDO shows the incremental additions to assets are less efficient than seasoned stores. Additionally, HBI is generating significant cash flow over and above the earnings they are reporting, while FDO realizes less cash than earnings, showing HBI is in a better position to fund future growth.

With our focus on "unexpected earnings" it is important that we look for clues in operating trends that may not be obvious to our competitors. Earnings Quality measures like the ones highlighted above complement our Growth Outlook metrics and are critical to our success.

Exhibit #2: Comparison of Asset Turnover for a high EQ vs. low

	High EQ example		*Low EQ example*	
	Hanesbrands (HBI)		Family Dollar (FDO)	
($ millions)	ye 2012	ye 2011	ye 2012	ye 2011
Sales Trailing 4Q	4,526	4,434	9,605	8,698
/Total Assets	3,632	4,035	3,687	3,121
= Asset Turnover	125%	110%	261%	279%
Change in Asset Turnover	15%		-18%	

Exhibit 3: Comparison of Earnings Surplus/<Shortfall for a

	High EQ example	*Low EQ example*
	Hanesbrands (HBI)	Family Dollar (FDO)
($ millions)	ye 2012	ye 2012
+ Cash flow from Ops(T4Q)	553.7	388.3
- Net Income (T4Q)	260.6	423.4
= Earnings surplus/<Shortfall>	293.1	-35.1