VALENS RESEARCH

UAFRS vs As-Reported Monthly Newsletter | December 27th, 2017

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"Overall, CFOs have come to view financial reporting largely as a compliance activity rather than as a vehicle of innovation designed to inform stakeholders and lower the cost of capital." – Dichev, Graham, Harvey, and Rajgopal in *Earnings Quality: Evidence from the Field*

In *Earnings Quality: Evidence from the Field*, the authors highlight many issues CFOs currently have with GAAP and IFRS. One of those issues is listed above, and gets to a core reason why Uniform Accounting is so important. As-Reported metrics do not do help inform stakeholders of a company's performance as they are constructed now. CFOs feel they are more of a detriment in communicating with shareholders than a tool.

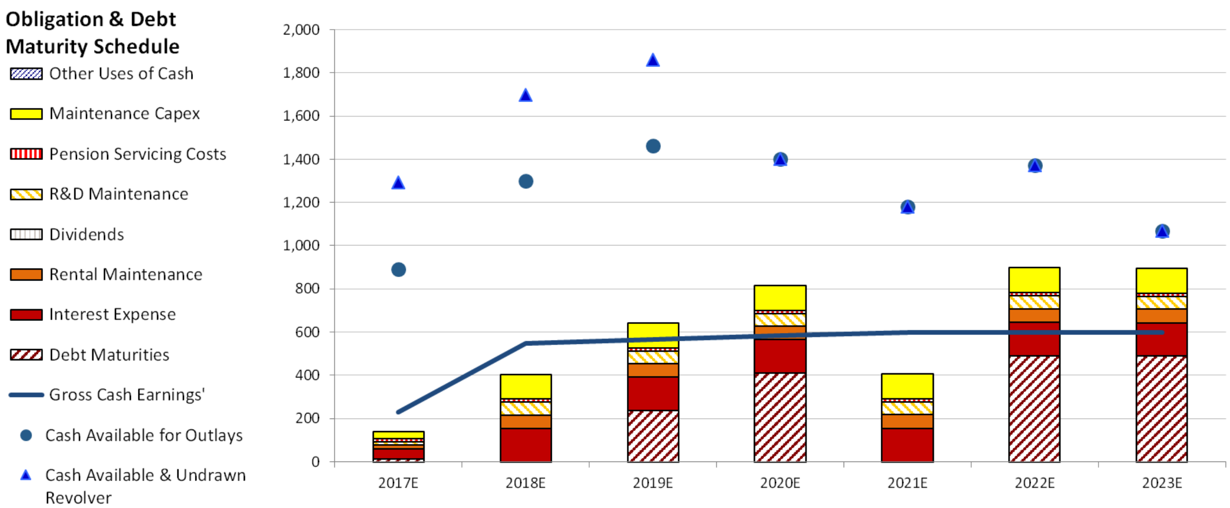
The rampant problems in reliability and comparability of GAAP and IFRS, in the U.S. and internationally, have been cited throughout academia, the investing community, and management teams themselves. UAFRS, Uniform Accounting has emerged as the clear solution, providing more reliable, comparable performance and valuation metrics.

Highlighted UAFRS vs As-Reported™ Dislocations (Read more about the UAFRS framework here.)

To access UAFRS analysis on these companies and over 6,000 more, click here.

UAFRS vs As-Reported – Major Variances This Month

AVP – Avon Products, Inc.



AVP - Avon Products, Inc.	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Change in Working Capital	270.9	123.4	141.8	89.4	50.8	-300.3	-353.8	-521.6	-613.1	633.3
R&D Expense	71.8	69.7	65.4	72.6	75.7	73.3	66.9	64.7	61.9	52.1
Operating Lease Expense	118.5	117.8	113.5	126.1	126.1	133.1	109.6	90.7	74.4	75.0
Interest Expense	112.2	100.4	104.8	87.1	92.9	104.3	117.9	108.8	123.0	136.6
Uniform Cash Flow From Operations	1042.5	1325.8	1142.0	1164.4	1269.3	1048.5	959.4	827.9	510.9	490.7
Cash Flow From Operations	589.8	748.1	782.0	702.0	655.8	556.1	535.6	359.8	112.1	60.4
% Variance	-43.4%	-43.6%	-31.5%	-39.7%	-48.3%	-47.0%	-44.2%	-56.5%	-78.1%	-87.7%
Uniform Net Assets	4148.3	4583.6	4791.4	5282.7	5533.2	5222.5	4669.9	3557.6	2347.9	2440.8
Total Assets	5716.2	6074.0	6823.4	7873.7	7735.0	7382.5	6492.3	5596.8	3870.4	3418.9
% Variance	37.8%	32.5%	42.4%	49.0%	39.8%	41.4%	39.0%	57.3%	64.8%	40.1%
Uniform Recovery Rate	36.6%	45.5%	44.1%	57.1%	15.8%	17.9%	25.2%	32.0%	22.7%	113.2%
Recovery Rate	63.5%	64.9%	72.6%	64.4%	70.2%	61.5%	67.9%	52.7%	34.7%	45.0%
% Variance	27.0%	19.4%	28.6%	7.3%	54.4%	43.6%	42.7%	20.7%	12.0%	-68.1%

AVP has regularly been viewed as a company with severe credit risk, with CDS that has consistently been above 500bps since the end of 2016, and above 900bps currently. Valens, on the other hand, has regularly pointed to AVP as a company that, while not the strongest UAFRS-based ROA company, typically deserved an iCDS below 500bps. While as-reported metrics showed a company with declining cash flow generation and significant leverage, UAFRS-adjusted metrics that understand the company's cash flow and obligations profile in a more holistic view were signaling a safer profile, even as cash flows have grown more challenged.

A big reason for that is the flawed treatment of cash flow from operations and the classification of metrics in the statement of cash flows in as-reported statements. Four of the biggest drivers of cash flow from operations are expenses or cash flow line-items that should clearly not be in this statement, but should rather be in either cash flow from investing activities or financing activities.

The first clear issue is changes in working capital. As a starting point "capital" is one of the key words in this line item (which is the changes in accounts receivable, accounts payable, inventory, and other short-term assets and liabilities). Fundamentally, companies that are putting money or taking money out of these line items are companies that are investing, or dis-investing, in their plans to grow or shrink their operations. While the function of turning inventory into cash through producing and selling a product is an operating activity, the decision to build inventory or shrink it is a strategic decision for the future plans for the business. For AVP, swings in working capital have had material impacts year-to-year on the company's cash flow from operations, which has been consistently understated since 2007. Specifically, over the last five years this line item has been both a $521mn headwind and a $633mn tailwind, adding undue volatility to the firm's cash flow from operations year-to-year.

The next two metrics, as highlighted below in other examples, are classic examples of investing activities masquerading as operating activities. Both R&D investment and operating lease investment represent investments in the company, as opposed to operating activities.

Depreciation expense, which shows up on the income statement, is added back for cash flow from operations, not just because it is a non-cash expense, but because it also represents a proxy of the company's capex, which is their decision to invest in the company's long-term assets to generate future cash flows. Operating lease expense is the company making the same decision, investing in assets that they will use to drive future cash flow production of the business, but spreading that investment over time. Therefore, to allocate it as an operating activity as opposed to investing activity is nonsensical. And yet, as-reported financial statements do.

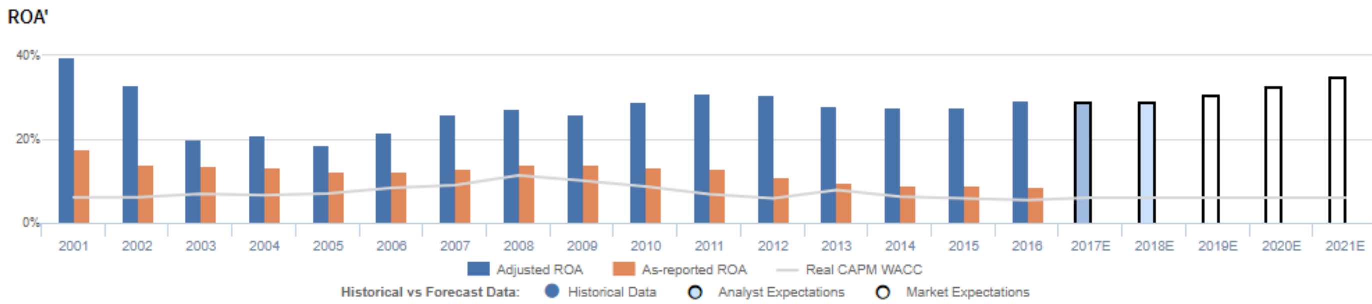
R&D investment should be viewed the same way. An investment in R&D is an investment in future product innovation for a company to drive future revenue, it is not an expense related to current revenues. By treating this investment as an operating expense, and passing it through the operating cash flows, changes in a management team's decisions around investing in the company's future can impact an investor's insight into the company's operating performance. The combined impact of allocating R&D investment and operating lease investment to AVP's cash flow from operations has been a consistent $100mn+ headwind, even as operating lease expense has fallen in recent years, distorting investors' analysis on the company.

Finally, allocating interest expense to the operating cash flows is almost comical when one pauses and thinks about it. Interest expense represents the cost of borrowing money, a decision around how the company is financed, and whether the company uses debt or equity to finance itself. If interest expense should be in operating cash flows, then why are dividends not? Clearly, interest expense should be removed from operating cash flows, and treated correctly as a financing cash flow, to represent where this decision falls. For AVP, with typically $100mn+ in annual interest expense, this has a material impact on understanding their cash flow generating potential.

After making these adjustments, investors can compare a company's real cash flows relative to obligations going forward, painting an important picture for understanding a company's credit risk. For AVP, one of the immediate signals that jumps out is that the company's uniform operating cash flows will be able to service all the company's operating obligations (non-debt-maturity related) going forward. Additionally, with the company boasting healthy liquidity levels, and a sizable expected cash build, the company has ample room to navigate their upcoming debt maturities.

By using UAFRS-adjusted metrics and thinking holistically about credit risk, a clearer picture of the company's safe credit emerges. By using UAFRS metrics, we are better able to understand a company's real cash generation, earnings, credit risk, and valuation potential, which AVP does an excellent job highlighting.

WAT – Waters Corporation

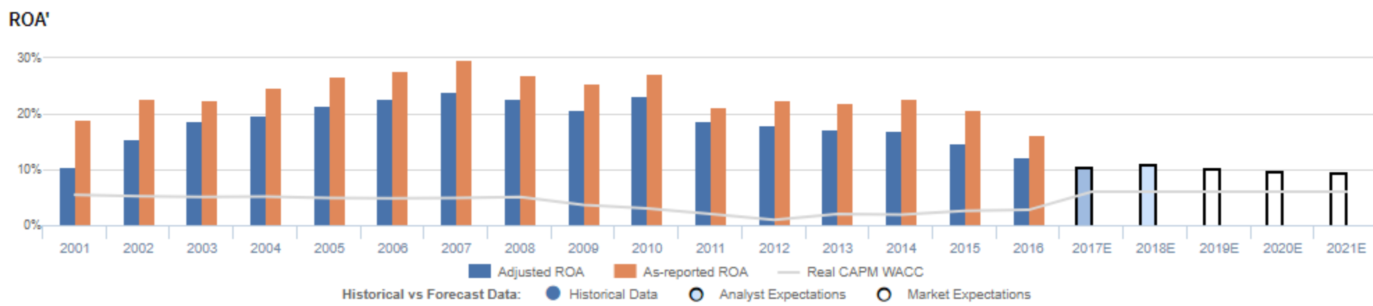


WAT - Waters Corporation	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Cash & Short-term Investments	693	429	630	946	1,281	1,539	1,804	2,055	2,399	2,813
Excess Cash	482	210	407	716	1,040	1,276	1,529	1,770	2,092	2,481
Operating Cash	211	219	223	231	241	263	275	285	307	332
Uniform Net Assets	1313.5	1428.9	1496.5	1558.0	1679.4	1827.8	1992.7	2079.6	2154.5	2241.3
Total Assets	1881.1	1622.9	1907.9	2327.7	2723.2	3168.2	3582.6	3874.7	4268.7	4662.1
% Variance	43.2%	13.6%	27.5%	49.4%	62.2%	73.3%	79.8%	86.3%	98.1%	108.0%
Uniform ROA	26.1%	27.2%	25.9%	29.2%	30.8%	30.7%	27.9%	27.6%	27.8%	29.2%
ROA	12.9%	14.1%	14.0%	13.3%	13.1%	11.1%	9.6%	9.1%	8.9%	8.8%
Uniform ROA vs ROA - Variance	13.2%	13.1%	12.0%	15.9%	17.8%	19.6%	18.4%	18.5%	18.9%	20.4%

Historically, WAT has carried a material amount of cash on their balance sheet as cash levels have risen from $693mn in 2007 to north of $2.8bn in 2016. Corporations inherently need some level of cash to operate their business, without which they would have liquidity issues and customers and suppliers would be hesitant to build long-term relationships with them. However, companies with substantial cash balances (above what one might view as “operating” cash) can see as-reported ROA diluted because of the substantial portion of the balance sheet that ends up being taken up by cash that is earning limited or no return, especially in the current environment. As such, if excess cash is not removed from the asset base of a company before looking at performance metrics, a company can appear to have substantially lower operating profitability (in terms of ROA) than it actually has.

Because WAT carries a material excess cash balance, as-reported metrics like ROA materially understate the company’s true profitability and capital efficiency versus UAFRS-based metrics. Without the excess cash adjustment, ROA has historically been understated by over 12%-20%. This can lead to investors and management believing that the company has weaker performance than is justified, depressing valuations.

HM B:CHE – H & M Hennes & Mauritz AB (publ)

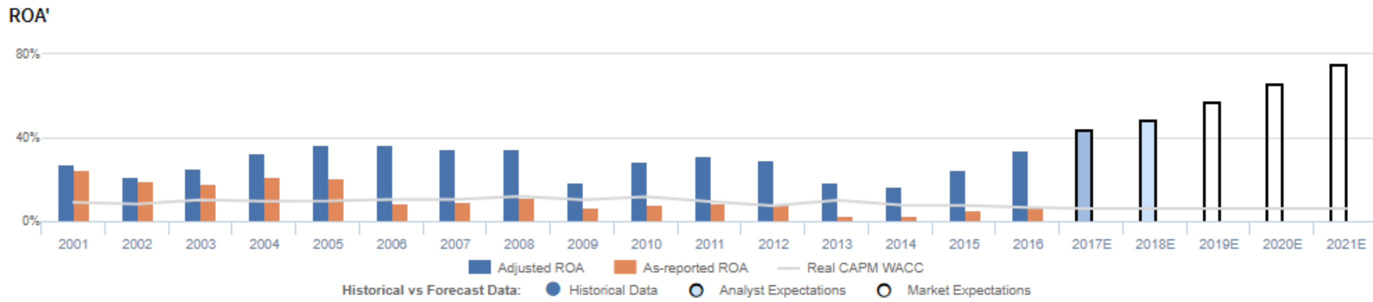


HM B - H & M Hennes & Mauritz AB (publ)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Rental Expense	8517.0	9850.0	12371.0	13021.0	12993.0	14056.0	15044.0	17176.0	20554.0	22332.0
Capitalized Operating Lease Investment	68758.4	79519.8	99872.1	101800.7	101581.8	110116.9	120698.7	137803.9	164905.7	175085.9
Uniform Earnings	14037.1	15556.3	17802.1	20286.9	17076.5	18396.5	18999.4	22046.1	23627.3	21484.5
Net Income	13588.0	15294.0	16384.0	18681.0	15821.0	16867.0	17093.0	19976.0	20898.0	18636.0
% Variance	-3.2%	-1.7%	-8.0%	-7.9%	-7.4%	-8.3%	-10.0%	-9.4%	-11.6%	-13.3%
Uniform Net Assets	58211.0	68491.2	85771.7	86900.7	90856.5	101529.0	110445.6	130571.0	160185.2	176682.8
Total Assets	41734.0	51243.0	54363.0	59182.0	60188.0	60173.0	65676.0	75597.0	85813.0	98579.0
% Variance	-28.3%	-25.2%	-36.6%	-31.9%	-33.8%	-40.7%	-40.5%	-42.1%	-46.4%	-44.2%
Uniform ROA	24.1%	22.7%	20.8%	23.3%	18.8%	18.1%	17.2%	16.9%	14.7%	12.2%
ROA	29.7%	27.1%	25.6%	27.1%	21.3%	22.6%	21.9%	22.6%	20.9%	16.1%
Uniform ROA vs ROA - Variance	-5.6%	-4.4%	-4.9%	-3.8%	-2.5%	-4.5%	-4.7%	-5.8%	-6.1%	-4.0%

HM B:CHE has had consistent, material operating leases each year. The decision management makes between investing in capex and investing in a lease is not a decision between an expense and an investment, but rather a decision in how management wants to finance their investments. If they would rather spend cash up front for the asset, they will spend capex. However, if they want to spread the cost of the asset over several years, they will instead choose to lease the asset. That said, as-reported accounting statements treat one as an investment, and the other as an expense that impacts the income statement.

Because HM B:CHE materially spends on operating leases, as-reported metrics like Net Income and ROA materially distort the company's true earnings and profitability versus UAFRS metrics. Specifically, the firm's asset base has been understated by 25%+ historically, and, as such, the firm's ROA has historically been overstated by 3%-6%. This can lead to investors and management believing that the company has better performance than in reality, leading to higher-than-warranted valuations.

ADBE – Adobe Systems Incorporated



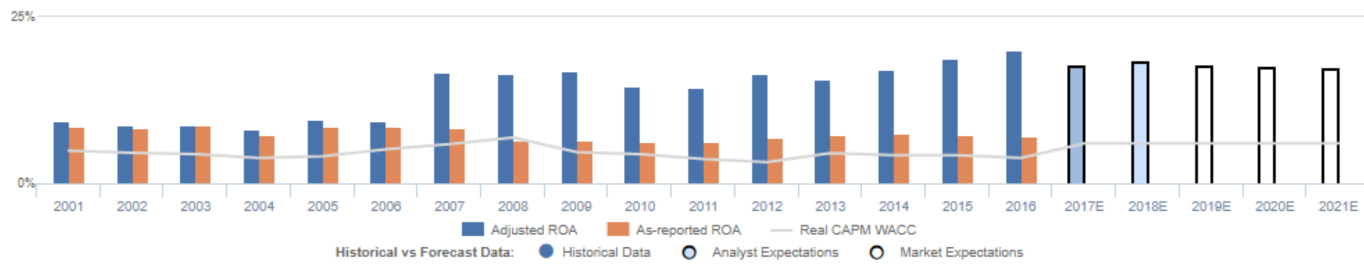
ADBE - Adobe Systems Incorporated	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
R&D Expense	662.1	565.1	680.3	738.1	742.8	826.6	844.4	862.7	976.0	1224.1
Capitalized R&D Investment	1845.3	2192.5	2359.9	2469.8	2511.9	2497.0	2630.2	2757.1	2858.2	3081.1
Uniform Earnings	935.7	1243.4	684.9	1118.9	1276.5	1271.1	856.3	781.5	1158.2	1677.1
Net Income	871.8	386.5	774.7	832.8	832.8	290.0	268.4	629.6	1168.8	1694.0
% Variance	-6.8%	-68.9%	13.1%	-25.6%	-34.8%	-77.2%	-68.7%	-19.4%	0.9%	1.0%
Uniform Net Assets	2711.2	3608.7	3686.0	3943.3	4103.5	4394.9	4552.8	4712.8	4695.9	4961.1
Total Assets	5821.6	7282.2	8141.1	8991.2	10040.2	10380.3	10785.8	11726.5	12707.1	14535.6
% Variance	114.7%	101.8%	120.9%	128.0%	144.7%	136.2%	136.9%	148.8%	170.6%	193.0%
Uniform ROA	34.5%	34.5%	18.6%	28.4%	31.1%	28.9%	18.8%	16.6%	24.7%	33.8%
ROA	11.5%	7.0%	8.2%	8.7%	7.7%	2.7%	2.6%	5.0%	7.6%	9.9%
Uniform ROA vs ROA - Variance	23.0%	27.5%	10.3%	19.6%	23.4%	26.2%	16.3%	11.6%	17.0%	23.9%

ADBE has regular material investments in R&D each year that as-reported financial statements treat as expenses. This violates one of the core principles of accounting, which is that expenses should be recognized in the period when the related revenue is incurred. R&D investment is an investment in the long-term cash flow generation of the company.

Because as-reported metrics treat R&D investment as an expense, as opposed to an investment, net income is artificially decreased. Net income is then materially understated relative to UAFRS-based Earnings, and can appear significantly more volatile than reality. As a result of this distortion, ADBE's as-reported ROA has historically been near cost of capital levels, while their Uniform ROA has been 3x-5x that historically. Investors may therefore believe that the firm is having less success with their R&D investments than they actually are. This leads to investors and management believing that the company has weaker performance than is justified.

CVS – CVS Health Corporation

ROA'

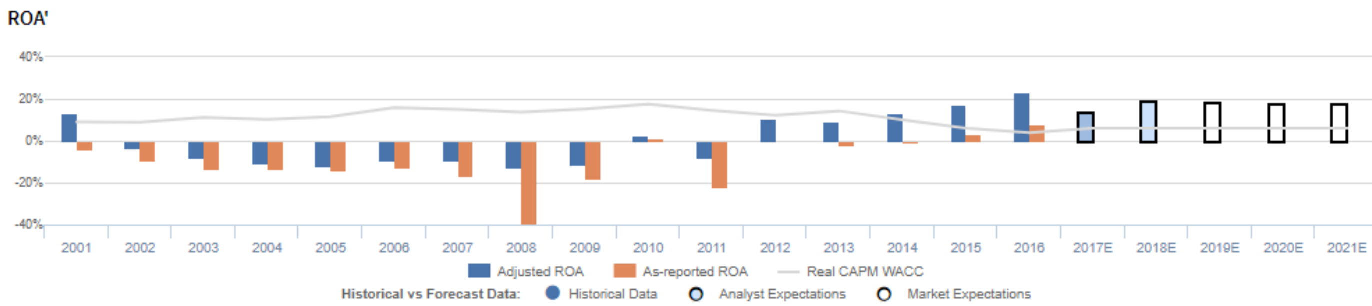


CVS - CVS Health Corporation	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Goodwill & Other Intangibles	34351.9	35940.0	35807.0	35453.0	36327.0	36148.0	36071.0	37916.0	51984.0	51760.0
Uniform Earnings	3718.1	4401.6	4828.2	4572.0	4684.4	5401.4	5794.9	6224.1	6940.9	7809.3
Net Income	2637.0	3212.0	3696.0	3427.0	3462.0	3864.0	4592.0	4644.0	5237.0	5317.0
% Variance	-29.1%	-27.0%	-23.4%	-25.0%	-26.1%	-28.5%	-20.8%	-25.4%	-24.5%	-31.9%
Uniform Net Assets	22304.8	26692.0	28655.2	31258.9	32396.4	32977.1	37124.8	36298.8	37206.8	38933.9
Total Assets	54721.9	60960.0	61641.0	62169.0	64543.0	66221.0	71526.0	74187.0	92437.0	94462.0
% Variance	145.3%	128.4%	115.1%	98.9%	99.2%	100.8%	92.7%	104.4%	148.4%	142.6%
Uniform ROA	16.7%	16.5%	16.8%	14.6%	14.5%	16.4%	15.6%	17.1%	18.7%	20.1%
ROA	8.4%	6.5%	6.6%	6.2%	6.2%	6.9%	7.2%	7.6%	7.3%	7.1%
Uniform ROA vs ROA - Variance	8.3%	10.0%	10.3%	8.4%	8.2%	9.5%	8.4%	9.6%	11.3%	13.0%

CVS has made a number of acquisitions over the past 10 years, with the most notable being its purchase of Caremark. As-reported financials show the price that a company pays for the assets of the acquisition as goodwill and operating intangibles on the balance sheet. However, these adjustments are purely accounting and not representative of the company's actual operational performance. This creates incomparability between CVS's profitability versus their peers by artificially inflating the asset base of their operating business.

Subsequent to the firm's acquisition of Caremark, their asset base has consistently been overstated by over 2x. Investors who have looked at the company's as-reported Total Assets when judging the company's performance, and who use an as-reported ROA metric as opposed to Uniform Asset and Uniform ROA metrics, are materially overstating the company's operating asset base and understating the company's economic profitability. In fact, traditional ROA has consistently been roughly around the cost of capital, as opposed to Uniform ROA levels of 15%-20% over the last 10 years. This can lead to investors and management believing that the company has weaker performance than is justified, resulting in poorer valuations.

INCY – Incyte Corporation



INCY - Incyte Corporation	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Stock Option Expense	10.1	15.0	10.0	15.7	30.0	39.9	39.9	64.1	72.3	98.6
Uniform Earnings	-104.1	-144.2	-148.1	28.9	-85.5	117.7	140.6	232.7	388.9	606.2
Net Income	-86.9	-178.9	-211.9	-31.8	-186.5	-44.3	-83.1	-48.5	6.5	104.2
% Variance	-16.5%	24.1%	43.1%	-210.4%	118.2%	-137.7%	-159.1%	-120.8%	-98.3%	-82.8%
Uniform Net Assets	1111.2	1144.7	1312.6	1155.0	1028.7	1129.1	1482.3	1779.1	2209.8	2632.2
Total Assets	275.7	232.4	712.4	489.6	329.0	330.4	629.6	796.5	1007.4	1638.6
% Variance	-75.2%	-79.7%	-45.7%	-57.6%	-68.0%	-70.7%	-57.5%	-55.2%	-54.4%	-37.7%
Uniform ROA	-9.4%	-12.6%	-11.3%	2.5%	-8.3%	10.4%	9.5%	13.1%	17.6%	23.0%
ROA	-17.0%	-39.2%	-18.2%	1.4%	-21.8%	0.2%	-2.1%	-0.4%	3.5%	7.7%
Uniform ROA vs ROA - Variance	7.6%	26.6%	6.9%	1.1%	13.4%	10.2%	11.6%	13.5%	14.1%	15.3%

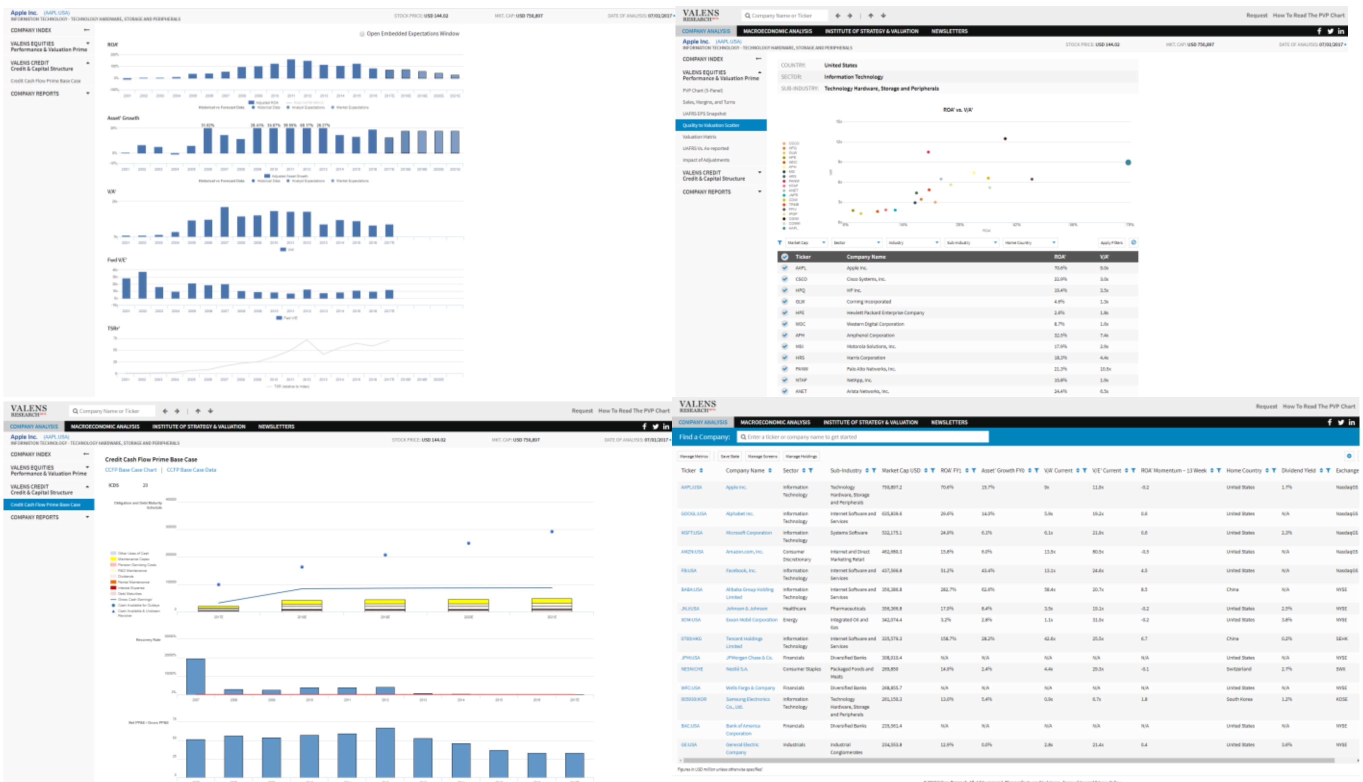
INCY has had material non-cash stock option expense since the company was founded. This is treated as an expense to the company in accounting statements, when it is actually a way for the company to give employees an ownership stake in the company. As such, this non-cash expense should be treated as dilution to equity holders and another claim against the Enterprise Value of the firm, as opposed to it being treated as an annual expense. This is especially true as, unless the company uses cash to buy shares (to suppress dilution for equity holders from the option grants being exercised), there is no cash impact on the company.

This type of non-cash expense is particularly important for early-stage biotech companies like INCY, where due to accounting distortions, a company that has recently experienced dramatic improvements in profitability can appear as though it has only barely achieve cost-of-capital profitability. As-reported unadjusted Net Income for INCY, which does not add back the Stock Option Expense and reallocate it as an impact on Enterprise Value, drives a negative ROA in most years, with a peak of just 8%, which is directionally different than the 10%+ Uniform ROA levels the company has generated since 2012. This can lead investors to incorrect conclusions regarding the firm, driving poorer valuations than is warranted.

Valens Research App

Valens has launched a new app.

The Valens Research app enables investors to use our cleaned up financial analytics, which shows over 130 adjustments made to 35 categories of the As-Reported Financials of over 4,500 companies... providing investors and researchers with more accurate numbers that tell the story for the companies you are analyzing and investing in. Subscribers to the database have access to both our Valens Research Performance & Valuation Prime cleaned up cash flow analytics platform, and our Valens Credit iCDS and Credit Cash Flow Prime debt analytics platform as part of the new app.



To read more about the new app and to sign up for access, click here.

Valens Research Glossary

Asset' – Net Asset' is calculated as Net Working Capital + Long Term Non-Depreciating Operating Assets (including Land and Non-Depreciating Operating Intangible Assets, excluding Goodwill and other acquisition-related Intangible Assets) + Inflation-Adjusted Net PP&E + Net capitalized R&D + Net Capitalized Leases + Net Depreciating Operating Intangible Assets

Earnings Call Forensics™ – Valens Research analysis includes a powerful proprietary process for studying and evaluating representations made by management during quarterly earnings calls and other public events. Valens uses tools and systems that other sell-side firms and credit agencies have been either unwilling or unable to use. Their reluctance to use these technologies often stems from their fear of endangering their relationships with management teams.

iCDS – Valens calculates proprietary, Intrinsic CDS (Credit Default Swap) for thousands of firms as their fundamentals change. Early markers can be invaluable in predicting price movements, particularly when seeing credit quality changes where no CDS are traded, where speculative or illiquid CDS fails to provide reliable information, or where rating agencies are too slow.

Most Compelling Earnings Call Forensics™ Inflections – Companies where Earnings Call Forensics™ (ECF™) has identified large shifts in management sentiment from quarter-to-quarter. The ECF™ Ratio above highlights the rate of incidence of Highly Confident and Excitement markers relative to Highly Questionable markers. The higher on the list a name appears, the larger the recent inflection between their two most recent ECF™.

Most Compelling Long Ideas – The most compelling long ideas based on all five proprietary value drivers: UAFRS-adjusted ROA, Asset' Growth, V/A', V/E', and TSRr. These are companies that Valens maintains a positive outlook on, relative to current market valuations. The higher on the list a name appears, the more positive Valens' opinion of the name is, based on our fundamental factors.

UAFRS-adjusted ROA – UAFRS-adjusted ROA is a cleaned up Return on Asset ratio, used to understand the operating fundamentals of the company. UAFRS-adjusted ROA is Earnings' divided by Asset'. Earnings' is calculated as Net Income + Special Items + Interest Expense + Depreciation and Amortization Expense + R&D Expense + Rental Expense + Minority Interest Expense + Pension Charges + LIFO to FIFO adjustments + Stock Option Expense + Purchase Accounting Cash Flow Adjustments - Non-Operating (Investment) Income - Asset Life Based Charge on Depreciating Assets. Asset' is Net Asset', or Net Working Capital + Long-Term Non-Depreciating Operating Assets (including Land and Non-Depreciating Operating Intangible Assets, excluding Goodwill and other acquisition related Intangible Assets) + Inflation Net PP&E + Net Capitalized R&D + Net Capitalized Leases + Net Depreciating Operating Intangible Assets.

UAFRS-adjusted ROA Momentum – UAFRS-adjusted ROA momentum is Valens' metric to understand the change in projected UAFRS-adjusted ROA and earnings momentum. This metric analyzes what the first forecast year projected UAFRS-adjusted ROA was one month ago, and what the projected UAFRS-adjusted ROA is today. This helps in identifying companies where analyst expectations for fundamentals are improving, and companies where analyst expectations for fundamentals are growing more negative.

TSRr – Total Shareholder Returns (TSR) Relative are traditionally known as the capital gains of the stock, adjusted for any stock splits or similar action, plus dividends, over some period of time. No adjustments are made to the well-known standard calculation. TSRr calculates the TSR relative to the performance of the S&P 500 in the USA, or some other major market index if more relevant when examining companies in other countries.

V/A' – V/A' is a cleaned up Enterprise Value to Net Asset ratio, used to understand the multiple on Net Asset that the debt and equity markets value the company at. Generally, businesses that produce higher UAFRS-adjusted ROA's and have no credit concerns or other reasons to believe they are not "going concern" businesses trade at higher V/A'. V is Enterprise Value', defined as Market Cap + Minority Interest + Adjusted Book Debt - Excess Cash. A' is Net Asset', or Net Working Capital + Long-Term Non-Depreciating Operating Assets (including Land and Non-Depreciating Operating Intangible Assets, excluding Goodwill and other acquisition related Intangible Assets) + Inflation Net PP&E + Net Capitalized R&D + Net Capitalized Leases + Net Depreciating Operating Intangible Assets.

V/E' – V/E' is a cleaned up Enterprise Value to Earnings ratio, used to understand the value the debt and equity markets ascribe to the company's cash flows. V is defined as Enterprise Value', which is Market Cap + Minority Interest + Adjusted Book Debt - Excess Cash. E' is defined as Earnings Prime. Earnings Prime is calculated as Net Income + Special Items + Interest Expense + Depreciation and Amortization Expense + R&D Expense + Rental Expense + Minority Interest Expense + Pension Charges + LIFO to FIFO adjustments + Stock Option Expense + Purchase Accounting Cash Flow Adjustments - Non-Operating (Investment) Income - Asset Life Based Charge on Depreciating Assets.

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