

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



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

The S&P non-GAAP (non-generally accepted accounting principles) 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 net margin by about 125bp. The 2018 S&P GAAP net margin also set a record, but 4Q18 GAAP net margin was down y/y as GAAP earnings were 68% of non-GAAP vs. 78% in 4Q17. This was despite many charges excluded from non-GAAP earnings in 4Q17 related to new deferred tax liabilities from the deemed repatriation tax. One time charges are generally seasonal and cyclical, i.e. higher in 4Q vs. other quarters and high in recessions. But the large GAAP vs. non-GAAP spread in 4Q18 is from several large idiosyncratic charges that don't 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 8 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 & 20 year average non-GAAP net margins for the S&P are 10.7%, 9.9%, 9.2% & 8.7%, respectively. History shows that S&P net margins are not mean reverting, but S&P net margins are cyclical. When the next recession comes S&P margins will contract. Recession driven margin contraction is coincident with recessions. Margin compression 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 & 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 & 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/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 adjustments for such in our valuation process. Complexities exist in assessing fair inclusions/exclusions from non-GAAP earnings and the economic meaning of the differences. For instance, companies write down assets when market value is lower than book value, but don't write them up if 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 avg. in line with history

The average GAAP/non-GAAP S&P EPS ratio since 1990 is 80%, and 86% out of recessions. For this cycle, the average ratio is 90.3% in the early years 2010-2014, but declined to 81.8% during 2015-2018, which can be mostly attributed to asset sale losses and impairments during the 2015-2016 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:  $(\text{Net Income} + \text{D\&A}) / (\text{CFO} - \text{stock option expense})$ . We subtract stock option expense from Cash Flow from Operations (CFO) and add Depreciation & Amortization (D&A) to Net Income. Stock option grants don't reduce aggregate FCF, but do reduce expected future FCF 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 5-15% higher than (CFO-option expense) vs. ~5% before that. Thus, non-GAAP earnings appear to be overstating cash generation lately vs. earlier this cycle.

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## Definitions

Amortization is the practice of spreading an intangible asset's (such as trademarks, franchise agreements, copyrights, cost of issuing bonds to raise capital).

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

Depreciation is the expensing of a fixed asset (such as buildings, equipment, office furniture, machinery etc.) over its useful life.

Earnings per share is calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

Generally Accepted Accounting Principles (GAAP) refer to the commonly accepted ways of recording and reporting accounting information. When an alternative method or metric is used for reporting and recording such accounting information it is known as non-GAAP. Examples of such non-GAAP metrics are earnings before interest and taxes, earnings before interest taxes, depreciation and amortization and adjusted earnings.

Margin describes borrowed money that is used to purchase securities.

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

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

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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