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The Power of Earnings Power

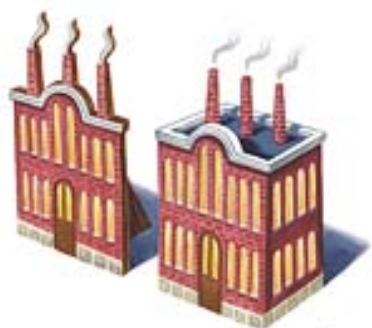
By HEWITT HEISERMAN JR.

EARNINGS DRIVE STOCK PRICES, but not all earnings are created equal. Consider UnitedHealth Group and Enron. Both companies made money in 2000, according to generally accepted accounting principles (GAAP). Indeed, each posted record profits that year. But one enjoyed authentic earnings power and was set to deliver huge market-beating returns in the years ahead, while the other had weak earnings and was headed for bankruptcy.

How can you distinguish 24-karat gold from iron pyrite on Wall Street?

The "Earnings Power Chart" can help. This approach rejects the published income statement, which has four substantial limitations: It omits investment in fixed capital, ignores investment in working capital, expenses intangible growth-producing initiatives like R&D and advertising, and treats stockholders' equity as a source of cost-free financing.


The Earnings Power Chart creates two alternate income statements: a "defensive statement" to make sure the business can fund itself, and an "enterprising statement" to test whether it is creating value. Strength in both is required for a company to qualify as blue-chip.



Lars Leetaru

Benjamin Graham, the father of security analysis, inspired this dual approach. The chief aim of the defensive investor, as Graham wrote in *The Intelligent Investor*, is to "avoid serious mistakes or losses." The primary objective of the enterprising investor is to own a security "that is both sound and more attractive than average."

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Graham's defensive investor is like a commercial banker, while the enterprising investor thinks like a venture capitalist. Unfortunately, the income statement contained in every annual report, 10-K and 10-Q doesn't meet the needs of either personality type.

For our defensive investor, omitting investment in fixed and working capital are limitations because they are uses of cash. A company goes bankrupt not for a lack of earnings, but for a lack of cash. Therefore, the defensive income statement expenses all investment as incurred. If the business still makes money after

deducting both these outlays (plus, of course, all other operating costs), then it has a defensive profit.

A defensive profit tells you the company is able to self-fund growth via internally generated free cash flow. A defensive loss, however, forces management to deplete the checking account, liquidate assets, sell more stock or visit the banker's window. None of these options benefits stockholders.

In 2000, Enron made \$896 million by GAAP. But it lost \$3.1 billion on a defensive basis. The \$4 billion gap came from large investments in fixed and working capital.

For our enterprising investor, expensing intangibles is a limitation because companies making intangible investments for the future are penalized. Like the venture capitalist, our enterprising investor is forward-oriented. For many companies, especially in "mind-based" industries like drugs, software and technology, intangibles prime the pump for downstream revenue growth and operating efficiencies. So, the enterprising approach converts intangibles from operating expenses to capital assets, and then depreciates them over their useful life (an educated guess, as with all depreciation schedules). This adjustment actually matches revenue with expenses -- an unfulfilled goal of most accrual accounting.

The enterprising income statement also charges for "borrowing" stockholders' equity (corporate net worth). By expensing equity as well as debt, all businesses, regardless of size, industry or capital structure, are treated as economic equals. Subtracting from revenue an imputed cost for owner-financing matches the venture capitalist's approach: The VC pencils in a required minimum return when deciding whether to invest in the potential next big thing.

If a company makes money after these two adjustments, then it is creating value for stockholders. A company creates value when its return on capital exceeds the cost of capital. Companies with enterprising losses, on the other hand, destroy value. If these losses persist, disgruntled stockholders will sell their shares, driving down the stock. A falling stock price puts a firm at a competitive disadvantage by making it harder to attract and retain key employees.

Enron had a \$1.4 billion enterprising loss in 2000, mostly due to the added cost of financing its billions of stockholders' equity.

The accrual income statement is too optimistic for our defensive investor, and too pessimistic for our enterprising investor.

To create an Earnings Power Chart, which is a four-box grid, you plot defensive profit or loss on the vertical axis, and enterprising profit or loss on the horizontal axis. The best box is the upper-right box. Businesses here generate free cash flow and high net returns on capital. The worst box is the lower-left, which means defensive and enterprising losses.

Unless you have a compelling reason, avoid lower-left boxers. During 1996-2000, Enron sat in the lower-left box. Although profitable according to GAAP, the energy trader did not possess authentic earnings power. Enron's stock traded as high as \$85 a share in mid-2000. But a user of the Earnings Power Chart knew Enron was a rotten apple years ahead of the crowd, even without understanding its accounting for special purpose entities and other unpleasantness. By December 2001, the stock was worthless.

Either the defensive or enterprising income statement almost always flags trouble ahead of the accrual P&L. In some cases -- Enron, for example -- both alternate ledgers are more predictive than the traditional version.

Currently, 3M, Dell, Blue Nile, Pepsi and UnitedHealth Group get high marks in the upper right box, while Asbury Automotive, DaimlerChrysler, 1-800-Flowers, and Gander Mountain are in the lower left corner.

After getting wiped out early in his investing career, Ben Graham famously demanded a "margin of safety" to guard against further losses. Suspicious of income statements, Graham's idea of a protective cushion was to pay less than two-thirds of a firm's net tangible assets.

If you are looking for a conservative growth stock, don't expect the company to sell at a fraction of hard book, as Graham demanded. Great businesses are rarely cheap. Use the Earnings Power Chart to make sure the business behind the stock is profitable in the broadest possible sense. This framework is your margin of safety. As the master carpenter tells his apprentice, "Measure twice, cut once."

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