GILD - Due Diligence Review: Forensic Accounting and Valuation

Description: Provides the due diligence required to distinguish the cash truth from reported earnings. We identify accounting irregularities and gimmicks, which inform our comprehensive, earnings-quality and valuation analysis. Our goal is to put investors on even footing with Wall Street insiders. We do not use any data feeds. We directly analyze 10-Ks and annual reports. Our expert analysis of over 50,000 annual reports gives us unrivaled experience and expertise on how to reverse accounting distortion.

>>> OUR RESEARCH PHILOSOPHY

Accounting data was not designed for equity investors, but for debt investors. Accordingly, accounting data must be translated into economic earnings in order to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available
2. Standard for all companies
3. A more accurate representation of the true underlying cash flows of the business

Why Doesn't Everyone Share our Philosophy?

1. Economic translation of accounting data is very difficult and time consuming. It requires gathering all the relevant financial information, much of which is buried deep in the Notes to the Financial Statements and Management Discussion & Analysis of 300-plus page annual reports and 10Ks.

2. Complacency: Many professional managers are happy with the status quo because they are too rich to care about making changes. They do not see a need for the extra work.

3. Picking stocks in a rising market is easy. As interest rates have declined for most of the past 20 years, the prosperous economic and political environment has given rise to a valuation tide that lifted almost all stocks. Over time, investors have given less weight to the importance of profitability and valuation in our opinion. Until recently, the market has proven them right.

4. Most professional investors are closet indexers (see our blog for more detail). They do not care much about performance nearly as much as the amount of assets they have under management. Because they are content to live off their management fees, performance is not so important. They see no need to invest much time in picking stocks that are not part of a predefined index.

5. The media (and Wall Street via the media) constantly bombard investors with short-term speculative stock recommendations. Constant sensationalism of often trivial data distracts investors from more important analytical work. Many investors become addicted to the news (i.e. multiple TVs blaring constantly in their offices) and believe that they need to watch, read or listen as often as possible. They fear missing important information that could drive them to take investment action every day. "People do not realize that the media is paid to get your attention. For a journalist, silence rarely surpasses [the value of] any word." - Nassim Taleb on page 53 of his book Fooled By Randomness (Texere 2001).

Contents:

We deliver the whole truth by incorporating critical data from the Financial Footnotes and MD&A that other firms miss.

1) Investment Rating
   a) Key highlights of recommendation and the drivers of our rating
   b) Figure 1: Details on the 5 criteria that determine the company’s rating & comparison with key benchmarks

2) Details on the Economic Vs Reported Earnings rating
   a) Explanation of difference between “economic” and “reported” earnings
b) Figure 2: Chart, over as many as 15 years, showing Economic Earnings Per Share vs Reported EPS
c) Figure 3: List of accounting distortions that make accounting EPS misleading
d) Figure 4: Chart of ROIC vs WACC over as many as 15 years
e) Explanation of “How To Measure Economic Earnings”
3) Free Cash Flow (FCF) Yield commentary
   a) Explanation of FCF Yield and its importance
   b) Figure 5: Chart of FCF Yield over as many as 15 years
   c) Insight into how to interpret the FCF Yield
4) Price-to-Economic Book Value Per Share (P/EBV) commentary
   a) Explanation of how to interpret P/EBV
   b) Figure 6: Chart of Economic Book Value Per Share vs Market Price over as many as 15 years
   c) More explanation on meaning and use of P/EBV
   d) Formula for P/EBV
5) Quantifying Market Expectations commentary
   a) Explanation of “expectations investing”
   b) Figure 7: Future performance required to justify valuation compared to historical performance
   c) Details on how the future performance embedded in the stock compares to the company’s past performance
d) Commentary on the difference between market expectations and past performance of the company
e) Definition of Growth Appreciation Period (GAP), aka Competitive Advantage Period (CAP)
f) Explanation of our dynamic discounted cash flow model and analysis
g) Details on how to calculate GAP and how to use it to make investment decisions
6) Appendix 1: Explanation and details on our ratings methodology and scale
7) Appendix 2: Details on how to convert Net Income into NOPAT and Reported Net Assets into Invested Capital
8) Appendix 3: Line-by-line reconciliation of Net Income to Economic Earnings
9) Appendix 4: Assumptions that drive our discounted cash flow and GAP analysis
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