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The Sustainable Earnings Indicator and Implications for Earnings Trends Executive Summary

The sustainability of earnings is a significant consideration for any investor. Variations between sustainable earnings and reported earnings can yield important insights into the direction of future reported earnings. One metric developed to track the relationship between sustainable earnings and reported earnings is the sustainable earnings indicator. Measured as sustainable net margin less reported net margin, the sustainable earnings indicator highlights any differences between sustainable earnings and reported earnings.

When the metric is positive, firms are taking nonrecurring charges, which depress reported earnings and reported net margin. The implication is that reported earnings may rebound in future periods. When the metric is negative, firms are reporting more nonrecurring gains, which raise reported earnings and reported net margin. The implication is that reported earnings may be declining in future periods.

The sustainable earnings indicator for our sample of non-financial firms was significantly negative during the years leading up to the Great Recession, as companies reported nonrecurring gains. These gains were replaced with nonrecurring charges in the recession and during the years immediately following the recession as excesses accumulated during pre-recession years were written off. Currently, the metric is positive and generally increasing, indicating that firms are tending to take more nonrecurring charges. The implication is that reported future earnings may be positively impacted.

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Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, the Lab thinks that independent research organizations, such as this Lab, have an important role to play in providing information to market participants.

Because the Lab is housed within a university, all of its research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Its focus is on issues that it believes will be of interest to a large segment of stock market participants. Depending on the issue, it may focus its attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in the work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. The Lab defines earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, its research may look into reporting practices that affect either earnings or cash flow, or both. At times, its research may look at stock prices generally, though from a fundamental and not technical point of view.

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Sustainable Earnings Indicator

Introduction and Definitions

The sustainable earnings indicator is measured as sustainable net margin less net margin. It indicates the difference between net margin calculated using sustainable earnings and net margin reported in the financial statements. Sustainable net margin and net margin are measured as follows:

- 1) Sustainable earnings are calculated as operating income - depreciation and amortization + interest and dividend income + equity in earnings - interest expense and is adjusted to an after-tax measure using a sustainable tax rate. Sustainable net margin is sustainable earnings divided by revenue.
- 2) Net margin is calculated as income before extraordinary items, from Capital IQ's Compustat database, divided by revenue.

Data and Methodology

The data used to calculate the sustainable earnings indicator are provided by Compustat through a license with the Wharton Research Data Services. Each data amount is for a rolling twelve-month period ending with the quarter end in question. For example, sustainable earnings amounts for June 30, 2017 represent amounts for the twelve months (four quarters) ended June 30, 2017.

The 20 analyzed industry groups are as follows:

GICS	Industry Group
1010	Energy
1510	Materials
2010	Capital Goods
2020	Commercial & Professional Services
2030	Transportation
2510	Automobiles & Components
2520	Consumer Durables & Apparel
2530	Consumer Services
2540	Media
2550	Retailing
3010	Food & Staples Retailing
3020	Food, Beverage, & Tobacco
3030	Household & Personal Products
3510	Health Care Equipment & Services
3520	Pharmaceuticals, Biotech, & Life Sciences
4510	Software & Services
4520	Technology Hardware & Equipment
4530	Semiconductors & Equipment
5010	Telecommunication Services
5510	Utilities

The 20 industry groups use the four-digit Global Industrial Classification System (GICS) and represent 10 overall sectors. The ten sectors with industry groups included in parentheses are: Energy (Energy), Materials (Materials), Industrials (Capital Goods, Commercial & Professional Services, and Transportation), Consumer Discretionary (Automobiles & Components, Consumer Durables & Apparel, Consumer Services, Media and Retailing), Consumer Staples (Food & Staples Retailing, Food, Beverage & Tobacco and Household & Personal Products), Health Care (Health Care Equipment & Services and Pharmaceuticals, Biotech & Life Sciences), Information Technology (Software & Services, Technology Hardware & Equipment and Semiconductors & Equipment), Telecommunications (Telecommunication Services) and Utilities (Utilities).

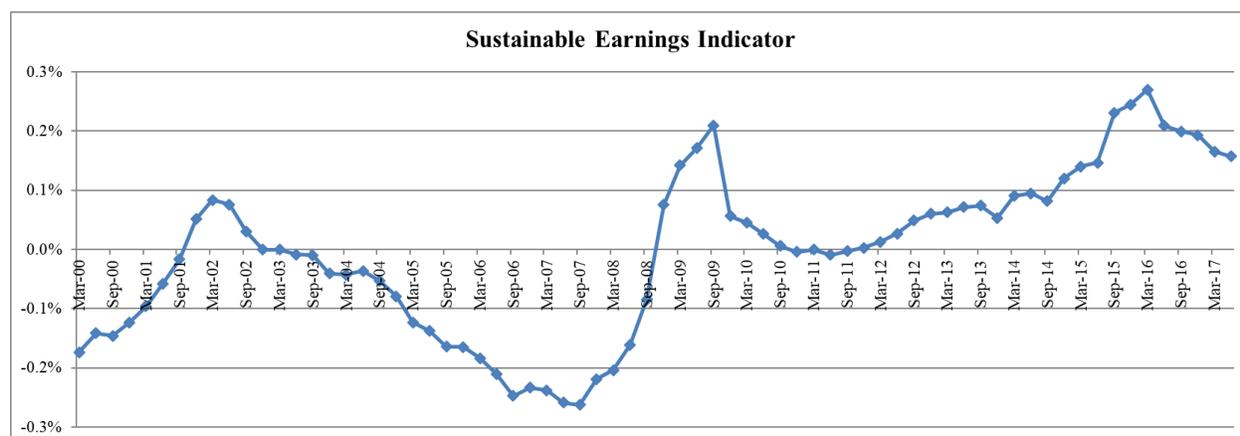
Summary of Results for All Non-Financial Companies

The sustainable earnings indicator for the twelve months ended June 2017 was 0.16%. This metric has decreased from the all-time peak of 0.27% in March 2016, but remains above historical averages. When the metric is positive, as it has been since 2011, it indicates that sustainable earnings exceed reported earnings. As such, nonrecurring charges and losses, which are excluded from sustainable earnings but not reported earnings, exceed nonrecurring gains. In effect, firms are taking more nonrecurring charges in the earnings they report. When the metric is negative, as it was especially during the years leading up to the Great Recession, reported earnings exceed sustainable earnings. Here, nonrecurring gains, which are excluded from sustainable earnings but not reported earnings, exceed nonrecurring losses. This occurs when companies are reporting more nonrecurring gains in their earnings.

A positive and rising sustainable earnings indicator, as has been the case since 2011, implies that companies are taking progressively more nonrecurring charges, which is weighing on reported earnings. The implication is that reported future earnings and net margin may benefit as firms slow the recording of these nonrecurring charges. Similarly, when the metric is negative and declining, as it was in the years prior to the Great Recession, firms are reporting progressively more nonrecurring gains. The implication in this case is that those nonrecurring gains will at some point give out and be followed by nonrecurring charges, perhaps as excesses experienced during good times are written off.

A graph of the sustainable earnings indicator for all non-financial firms in our sample is provided below.

All Non-financials, Q1 2000 – Q2 2017

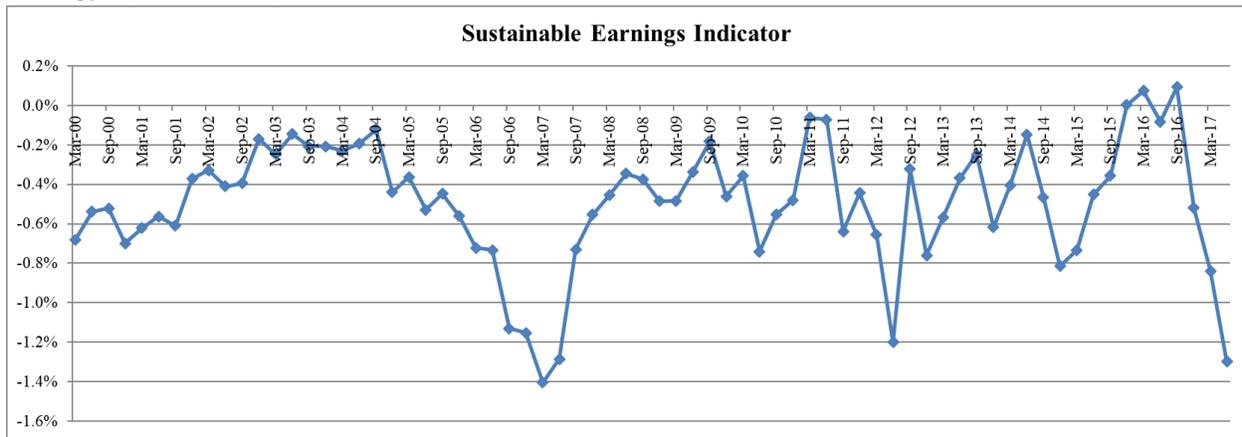


In the paragraphs that follow, we look at the sustainable earnings indicator for two industries, one with a negative and declining sustainable earnings indicator and one with a positive and rising indicator.

Industry with Negative and Declining Sustainable Earnings Indicator

The sustainable earnings indicator for the energy industry is provided below.

Energy, Q1 2000 – Q2 2017

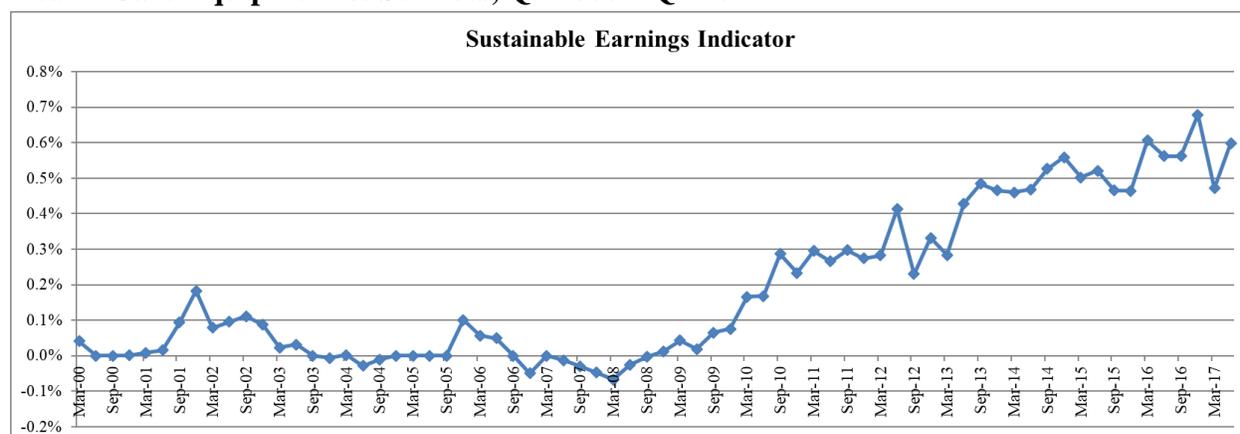


After peaking in September 2016 at 0.09%, the sustainable earnings indicator for the Energy industry has dropped sharply to -1.30% in June 2017. The metric has, however, remained mostly negative since 2000. The significant drop since 2016 indicates that firms are recording significant nonrecurring gains, which are not likely to be continued.

Industry with Positive and Rising Sustainable Earnings Indicator

Next we take a closer look at an industry with a positive and rising sustainable earnings indicator: Health Care Equipment & Services.

Health Care Equipment & Services, Q1 2000 – Q2 2017



The sustainable earnings indicator for Health Care Equipment & Services was 0.60% in June 2017. It has trended upwards ever since March 2008. Firms in this industry are taking more nonrecurring charges than gains, suggestive of a possible positive effect for reported earnings in future years.

Summary and Conclusion

The sustainable earnings indicator is a unique metric that seeks to anticipate future trends in reported earnings. When companies are taking nonrecurring charges, those charges depress reported earnings and push the sustainable earnings indicator upward. The implication is that these charges will, at some point, slow, and reported earnings will move higher. When firms are recording nonrecurring gains, those gains raise reported earnings and push the sustainable earnings indicator lower. The implication is that these gains will also slow, and may be replaced by charges, pushing reported earnings lower.

Thus a negative and falling sustainable earnings indicator is a precursor for lower future earnings. A positive and rising sustainable earnings indicator is a leading indicator for higher future earnings.

In the results for the full sample presented here, the sustainable earnings indicator is positive and has generally been on an upward trend since 2011. Firms are taking nonrecurring charges. The

implication is that firms may enjoy higher reported earnings in future years. Industry Results are also presented, with a close look at two of them. The sustainable earnings indicator for energy is negative and declining, as companies report nonrecurring gains. The indicator for healthcare equipment and services is positive and growing as firms take nonrecurring charges.