



Net Operating Profit After-Tax (NOPAT) & NOPAT Margin

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Net operating profit after-tax (NOPAT) is the unlevered, after-tax operating cash generated by a business. It represents the true, normal and recurring profitability of a business. GAAP earnings or, even worse, [non-GAAP earnings](#), are highly unreliable and are subject to misleading [management manipulation](#).

As the numerator in our return on invested capital ([ROIC](#)) calculation, NOPAT is a very important value, and we place a great deal of importance on getting it right.

Figure 1: How to Calculate NOPAT

| <i>Operating</i> | <i>Financing</i> |
|---------------------------------|----------------------------------|
| Operating Revenue | Net Income |
| – Operating Expenses | + Adj. for Capitalized Expenses |
| – Hidden Items | Adjusted Net Income |
| EBIT | + Increase in Equity Equivalents |
| + Goodwill Amortization | – Other Income |
| EBITA | + Other Expenses |
| + Adj. for Capitalized Expenses | – Hidden Items |
| + Income Equivalents | + Interest Expense After Taxes |
| NOPBT | NOPAT |
| – Cash Operating Taxes | |
| NOPAT | |

Sources: New Constructs, LLC and company filings

When we calculate NOPAT, we make [numerous adjustments](#) to close accounting loopholes and ensure apples-to-apples comparability across thousands of companies. A company shouldn't be able to hide from its mistakes, for instance, [hidden, unusual losses](#).

Figure 2 shows how we calculate NOPAT margin. NOPAT margin measures the amount of NOPAT generated from a firm's total operating revenue and provides insights into the operating efficiency of a business.

Figure 2: How to Calculate NOPAT Margin

$$\text{NOPAT} / \text{Total Operating Revenue} = \text{NOPAT Margin}$$

Sources: New Constructs, LLC and company filings

Figure 3 shows the companies with the most under/overstated GAAP earnings as compared to NOPAT as of April 8, 2016.



Figure 3: Companies with Most Understated/Overstated Earnings as of April 8, 2016

| Ticker | Name | NOPAT | GAAP Net Income | Misleading Earnings |
|----------------------------------|----------------------|------------|-----------------|---------------------|
| Most Understated Earnings | | | | |
| APA | Apache Corp | (\$233) | (\$23,119) | \$22,885 |
| CHK | Chesapeake Energy | \$205 | (\$14,856) | \$15,061 |
| DVN | Devon Energy | \$133 | (\$14,459) | \$14,592 |
| GE | General Electric | \$6,822 | (\$6,144) | \$12,966 |
| FCX | Freeport-McMoRan | \$24 | (\$12,293) | \$12,263 |
| Most Overstated Earnings | | | | |
| GSK | GlaxoSmithKline | \$6,845 | \$12,474 | (\$5,628) |
| CVX | Chevron Corp | (\$1,508) | \$4,587 | (\$6,095) |
| LYG | Lloyds Banking Group | (\$7,108) | \$2,239 | (\$9,438) |
| NVS | Novartis AG | \$8,341 | \$17,783 | (\$9,441) |
| ETR | Entergy Corporation | (\$25,047) | (\$177) | (\$24,871) |

Sources: New Constructs, LLC and company filings. Only includes companies with positive NOPAT

Per Figure 3, Entergy Corporation's NOPAT is \$24.8 billion less than its already negative GAAP earnings. Our NOPAT calculation for ETR [can be seen here](#). You can see that due to large losses from unconsolidated subsidiaries, Entergy's operating expenses were significantly higher than in previous years, which lead to the drastic decline in NOPAT from the prior year.

Novartis (NVS), Lloyds Banking Group (LYG), Chevron (CVX) and GlaxoSmithKline (GSK) also have significantly overstated GAAP net income after adjustments for [non-operating expenses](#), [expenses or income hidden in operating earnings](#), or [asset write downs](#) are made. [Here's the Adjustment Page from our model](#), which shows exactly how we adjust Chevron's GAAP Net Income to calculate NOPAT. We also show how to convert Total Assets to [Invested Capital](#).

On the other hand, Apache Corp's (APA) GAAP net income greatly understates its NOPAT. See our NOPAT calculation for APA each year [dating back to 1998 here](#). In 2015, Apache Corp had write-downs totaling over \$27 billion. Because asset write-downs are an unusual charge and distort recurring core profitability, we remove them from our NOPAT calculation. To ensure profitability metrics aren't distorted, our models capture the after-tax value of write-downs in [invested capital](#). Such large write-downs in 2015 may have kept Apache's NOPAT higher, but they drove down its return on invested capital (ROIC) from 4% in 2014 to -0.4% in 2015.

Chesapeake Energy (CHK), Devon Energy (DVN), General Electric (GE), and Freeport-McMoRan (FCX) each reported GAAP net income that understated the true recurring profits of their business operations as well. See the conversion of General Electric's GAAP net income to NOPAT [here](#).

Our models and calculations are 100% transparent because we want our clients to know how much work we do to ensure we give them the best earnings quality and valuation models in the business.

This article originally published on [September 16, 2019](#).

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, sector, style, or theme.



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