Only One Sector Has A Rising ROIC

The earnings recession is worse than it looks on the surface. Based on footnotes adjustments (featured by HBS & MIT Sloan), we show that earnings distortion reached levels not seen since the tech bubble and the financial crisis. While GAAP earnings are down 1% over the trailing twelve months (TTM), core earnings are down 6%.

The core fundamentals of businesses are declining in nearly every sector. 10 out of 11 sectors have declining returns on invested capital (ROIC).

Only one sector, the Telecom sector, has a rising ROIC. Unsurprisingly, Telecom is also the top-rated sector according to our sector rating methodology and earns our Very Attractive rating. The Telecom sector – and specifically BCE Inc. (BCE: $48/share) – is this week's Long Idea.

Improving Returns in Telecoms

Figure 1 compares the ROIC for all 11 sectors and ranks them by the change in their ROIC from 2018 to the TTM period.

Figure 1: TTM ROIC and Change from 2018-TTM by Sector

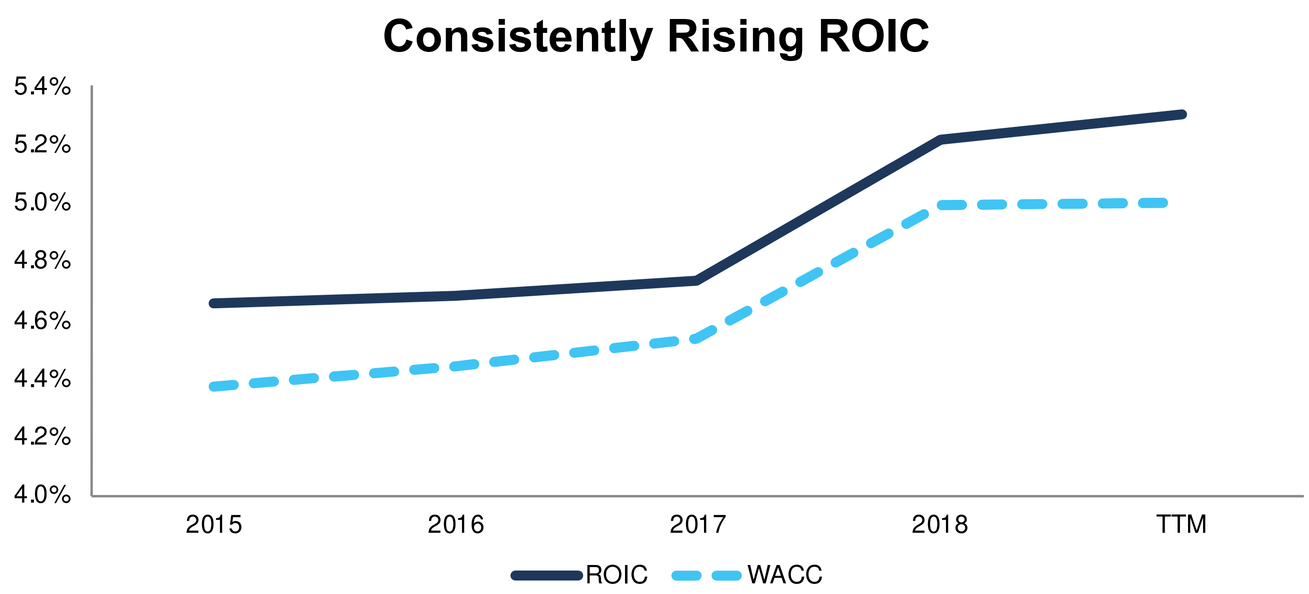
Sector	TTM ROIC	TTM - 2018 ROIC
Telecom	5.3%	0.1%
Utilities	3.4%	-0.1%
Healthcare	7.5%	-0.3%
Financials	7.1%	-0.4%
Industrials	7.6%	-0.5%
Real Estate	5.2%	-0.5%
Consumer Non-cyclicals	7.9%	-0.8%
Consumer Cyclicals	7.9%	-0.8%
Energy	4.1%	-1.0%
Basic Materials	5.4%	-1.3%
Technology	14.2%	-1.5%

Sources: New Constructs, LLC and company filings.

The Technology sector has the highest ROIC by a long shot, but it also has the biggest TTM decline in ROIC. Telecom, on the other hand, has a below-average ROIC, but it's the only sector whose ROIC improved in 2019.

Not only does the Telecom sector have a rising ROIC over the TTM period, its ROIC has risen every year since 2015, as shown in Figure 2. The sector also generates consistently positive economic earnings due to the fact that its ROIC is higher than its weighted average cost of capital (WACC).

Figure 2: Telecom ROIC vs. WACC: 2015-TTM[1]



Sources: New Constructs, LLC and company filings.

Improving margins are driving the rising ROIC for this sector. The aggregate NOPAT margin for the sector rose from 10.2% in 2015 to 12.6% TTM. Invested capital turns have fallen from 0.46 to 0.42 over the same times. Firms in this industry have become less efficient at turning capital into revenue, but they've become much more efficient at cutting costs and turning more revenue into profit.

Appendix II shows NOPAT margin and invested capital turns for all 11 sectors going back to 1998.

While the Telecom sector is profitable overall, profitability is highly concentrated. Just four companies – Verizon (VZ), Nippon Telegraph and Telephone (NTTYY), BCE Inc. (BCE), and America Movil (AMX) – earned $19 billion in economic earnings over the TTM period. The remaining 33 companies we cover in the sector combined for $14 billion in economic losses.

This high level of concentration proves diligence remains important. The Telecom sector may be Very Attractive overall, but there are still plenty of risky stocks in the sector that investors should avoid.

One Stock to Buy in the Telecom Sector

Investors looking to find value in the Telecom sector should start by looking at the four most profitable companies in the industry per above. We already made the case for why investors should buy VZ in our article "Earn Double the 30-Year Treasury Yield with This Pick".

BCE is another one of our top picks in the sector. The Canadian telecom giant shares many of the same traits that make us bullish on Verizon, including:

- The fastest network in its market, which allows it to grow its market share while also increasing its average revenue per user
- Growth potential over the next several years due to the upcoming deployment of 5G technology
- A cheap valuation and high dividend yield, which is supported by ample free cash flow

From 2015-2018, BCE grew its after-tax operating profit (NOPAT) by 4% compounded annually while maintaining a consistent ROIC of ~8%. Over the TTM period, NOPAT is up 3% year-over-year while ROIC remains steady.

Meanwhile, BCE's stock has been almost flat, up just 2% over the past five years. It appears that the market does not recognize the value of this company's cash flows.

[1] See Appendix I for analysis for ROIC from 1998 to present.

At its current valuation of $48/share, BCE has a price to economic book value (PEBV) of 0.8. This ratio means the market expects BCE's NOPAT to permanently decline by 20%. For a company with BCE's track record of consistent profit growth, this expectation seems overly pessimistic.

If BCE can maintain its 2018 NOPAT margin of 18% and grow NOPAT by 2% compounded annually for the next decade, the stock is worth $70/share today, a 46% upside to the current stock price. See the math behind this dynamic DCF scenario.

BCE also offers a 5% dividend yield, which is well supported by the cumulative $9 billion (22% of market cap) in free cash flow it earned from 2015-2018. Investors in BCE get both a steady income and the opportunity for capital appreciation.

The Rest of the Market

While Telecom is the only sector with a rising ROIC over the TTM period, looking at the recent trends in ROIC for the rest of the market provides important insights. Figures 2-11 show the aggregate ROIC and WACC for every other sector from 2015-TTM.

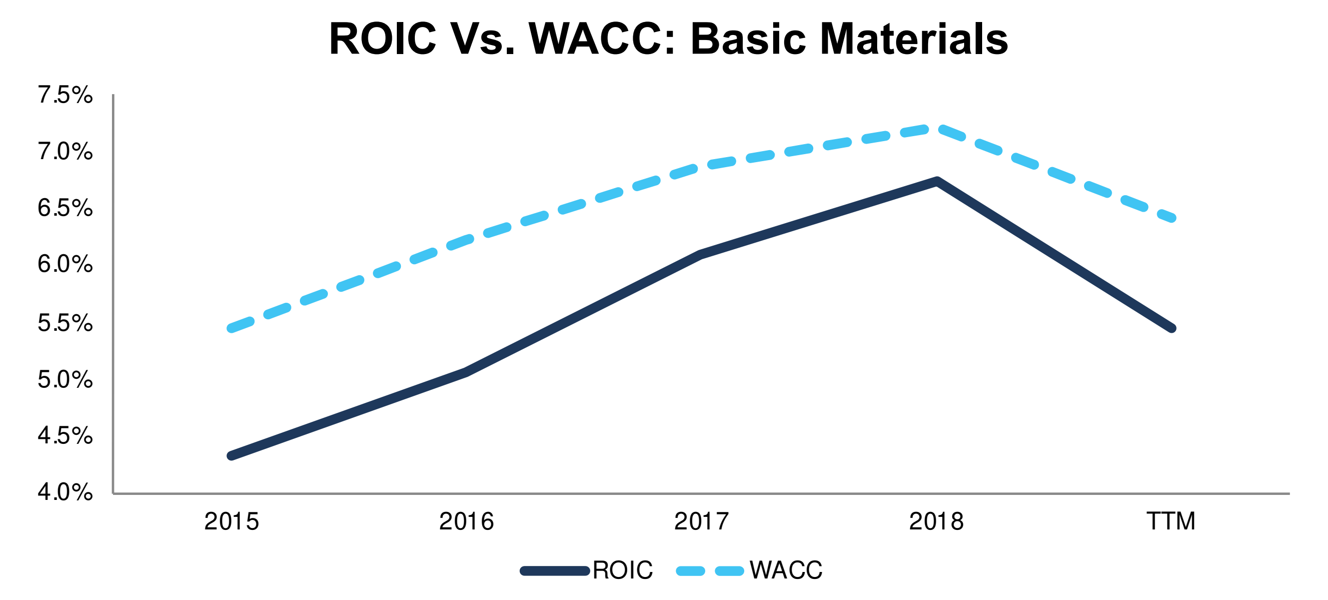
Investors who want to see a longer-term view can find charts of ROIC vs. WACC going back to 1998 for every sector in Appendix I.

Investors who are curious about the drivers of ROIC can find NOPAT margin and invested capital turns for each sector going back to 1998 in Appendix II.

Basic Materials

Figure 3 shows the ROIC for the Basic Materials sector declined over the TTM period after rising steadily from 2015-2018. NOPAT margin fell from 10.8% in 2018 to 9.5% TTM, while capital turns fell from 0.62 to 0.57. See the Appendices for analysis of ROIC vs WACC, NOPAT margins and invested capital turns back to 1998.

Figure 3: Basic Materials ROIC vs. WACC: 2015-TTM

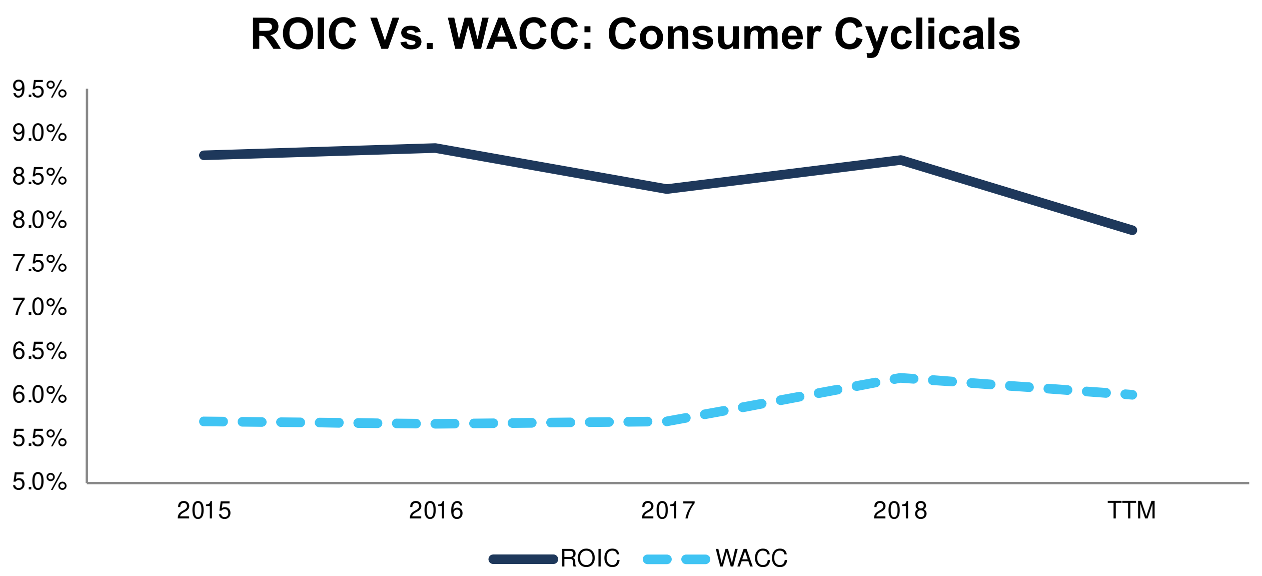


Sources: New Constructs, LLC and company filings.

Consumer Cyclicals

Figure 4 shows the ROIC for the Consumer Cyclicals sector declined from 8.7% in 2015 to 7.9% TTM. This decline is the result of invested capital turns falling from 1.26 in 2015 to 1.17 TTM. See the Appendices for analysis of ROIC vs WACC, NOPAT margins and invested capital turns back to 1998.

Figure 4: Consumer Cyclicals ROIC vs. WACC: 2015-TTM

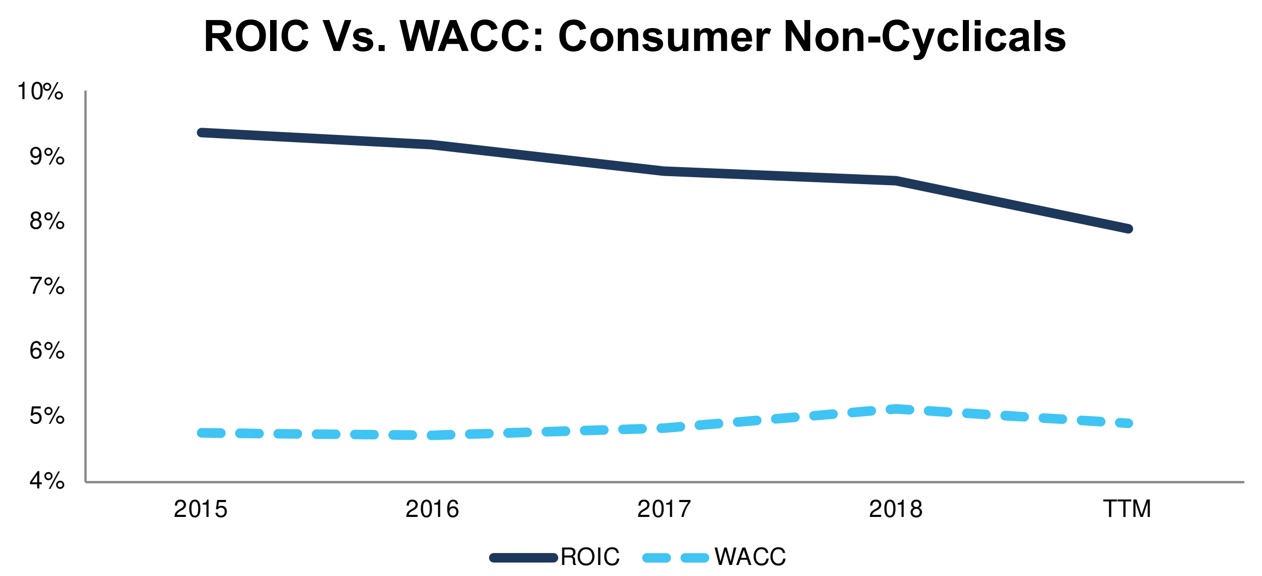


Sources: New Constructs, LLC and company filings.

Consumer Non-Cyclicals

Figure 5 shows ROIC for the Consumer Non-Cyclicals sector has steadily declined since 2015. As we noted when we put Mondelez (MDLZ) in the Danger Zone, the rise of e-commerce and changing consumer tastes have diminished the competitive advantages that previously helped companies in this industry earn outsized returns. The declining advantage manifests in the sector's falling NOPAT margins, down from 6.4% in 2015 to 5.8% TTM. See the Appendices for analysis of ROIC vs WACC, NOPAT margins and invested capital turns back to 1998.

Figure 5: Consumer Non-Cyclicals ROIC vs. WACC: 2015-TTM

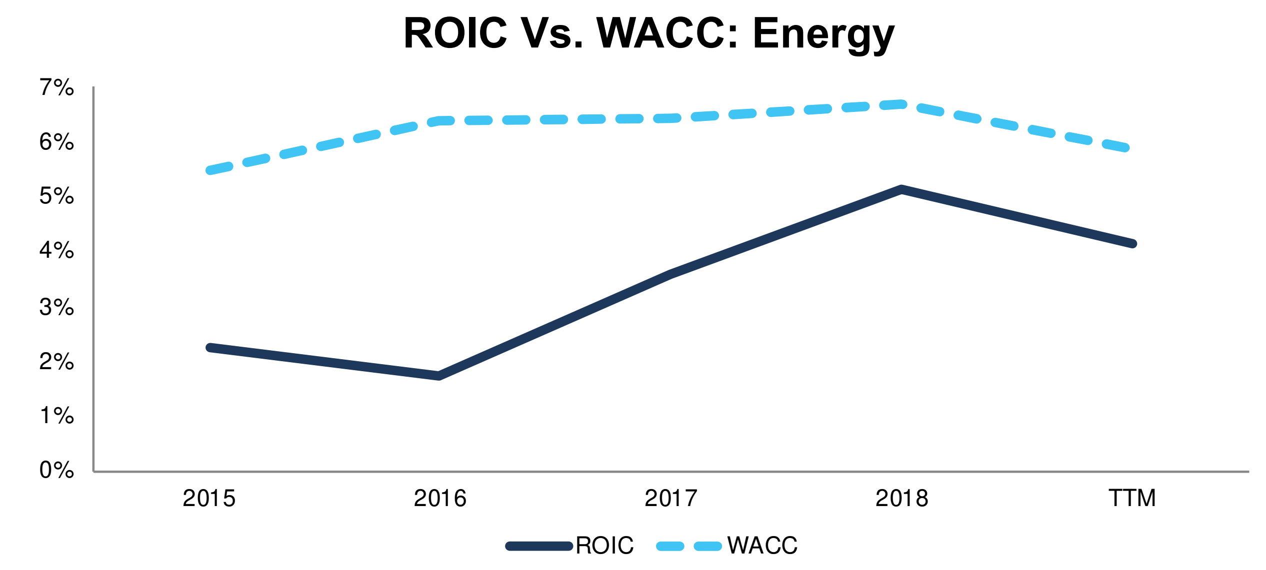


Sources: New Constructs, LLC and company filings.

Energy

Figure 6 shows ROIC rebounded from 2016-2018 due to a combination of rising oil prices and tax cuts. NOPAT margins rose from 4.1% in 2015 to 8.2% in 2018. But, margins fell over TTM and brought ROIC down with them. See the Appendices for analysis of ROIC vs WACC, NOPAT margins and invested capital turns back to 1998.

Figure 6: Energy ROIC vs. WACC: 2015-TTM

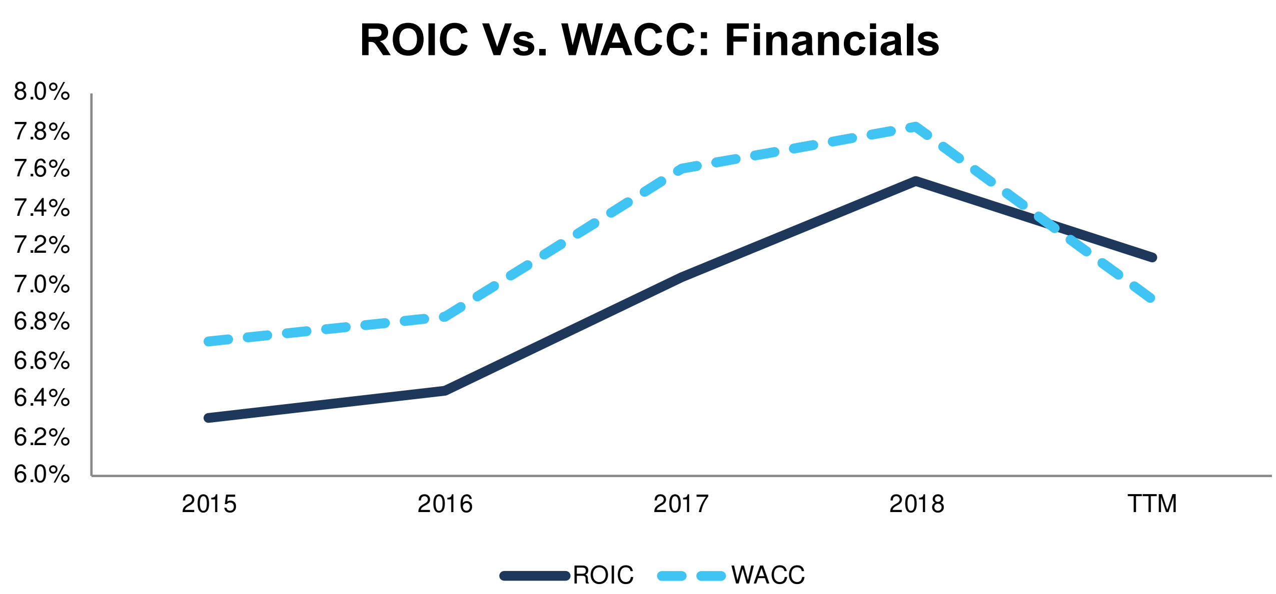


Sources: New Constructs, LLC and company filings.

Financials

Figure 7 shows ROIC declined over the TTM for the Financials sector, as NOPAT margins fell from 15.2% to 13.2%. But, WACC declined by an even larger amount; so the sector generated positive economic earnings. See the Appendices for analysis of ROIC vs WACC, NOPAT margins and invested capital turns back to 1998.

Figure 7: Financials ROIC vs. WACC: 2015-TTM

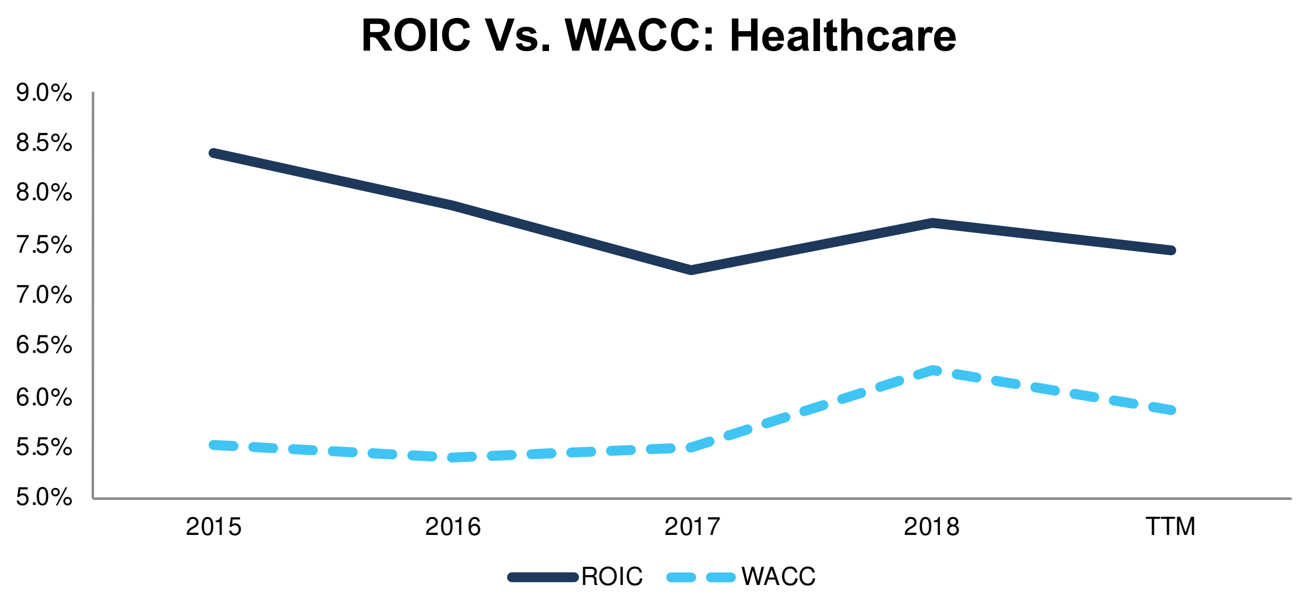


Sources: New Constructs, LLC and company filings.

Healthcare

Figure 8 shows ROIC for the Healthcare sector declined from 8.4% in 2015 to 7.5% TTM. This decline is driven by aggregate NOPAT margin for the sector declining from 10.4% to 8.9% over the same time. See the Appendices for analysis of ROIC vs WACC, NOPAT margins and invested capital turns back to 1998.

Figure 8: Healthcare ROIC vs. WACC: 2015-TTM

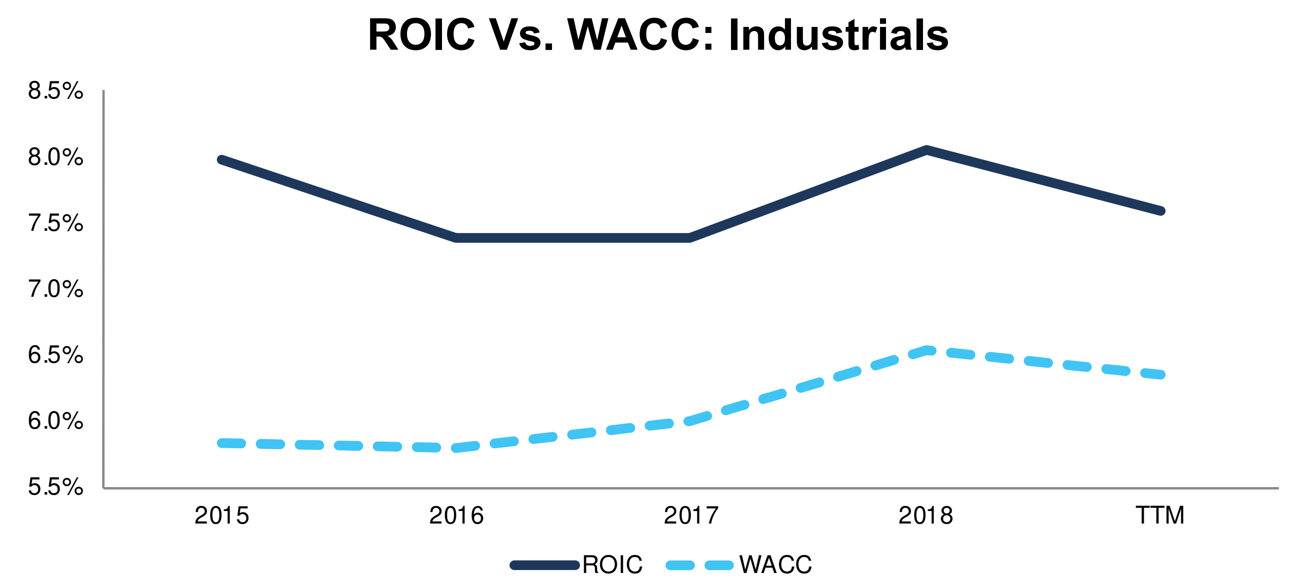


Sources: New Constructs, LLC and company filings.

Industrials

Figure 9 shows ROIC for the Industrials sector declined from 8% in 2015 to 7.6% TTM. This decline is driven by aggregate invested capital turns declining from 0.87 to 0.83 over the same time. See the Appendices for analysis of ROIC vs WACC, NOPAT margins and invested capital turns back to 1998.

Figure 9: Industrials ROIC vs. WACC: 2015-TTM

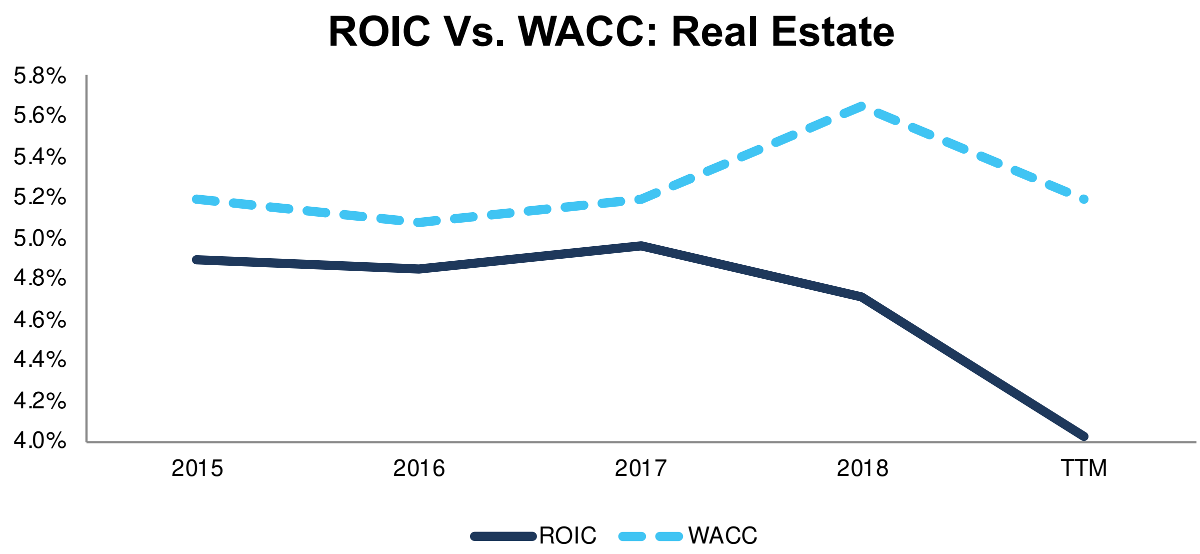


Sources: New Constructs, LLC and company filings.

Real Estate

Figure 10 shows ROIC for the REIT sector declined in 2018 and over the TTM period. Capital turns are up slightly, but NOPAT margins fell sharply over the last two years, from 24.9% in 2017 to 18.3% TTM. This sharp decline in ROIC explains why Real Estate is the worst rated sector according to our sector rating methodology. See the Appendices for analysis of ROIC vs WACC, NOPAT margins and invested capital turns back to 1998.

Figure 10: Real Estate ROIC vs. WACC: 2015-TTM

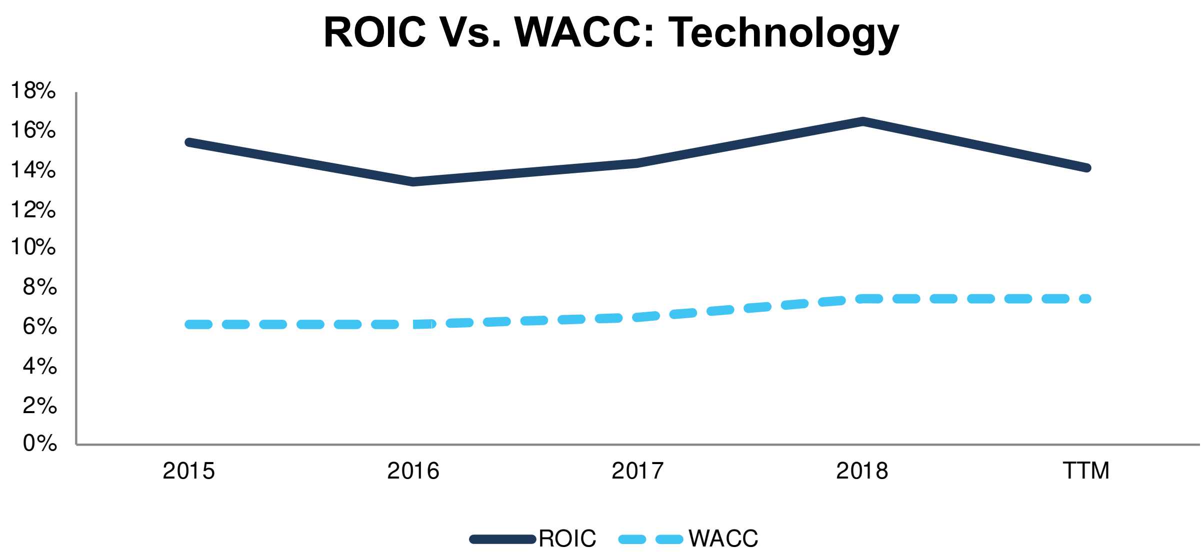


Sources: New Constructs, LLC and company filings.

Technology

Despite the decline over the TTM period, the Technology sector still has the highest ROIC of any sector by a wide margin. The decline is driven by a few mega-cap companies. Notably, Apple's (AAPL) ROIC declined from 129% to 98% over the past year. Aggregate NOPAT margins are down from 15.7% in 2018 to 14.2% TTM, while aggregate capital turns are down from 1.05 to 0.99. See the Appendices for analysis of ROIC vs WACC, NOPAT margins and invested capital turns back to 1998.

Figure 11: Technology ROIC vs. WACC: 2015-TTM

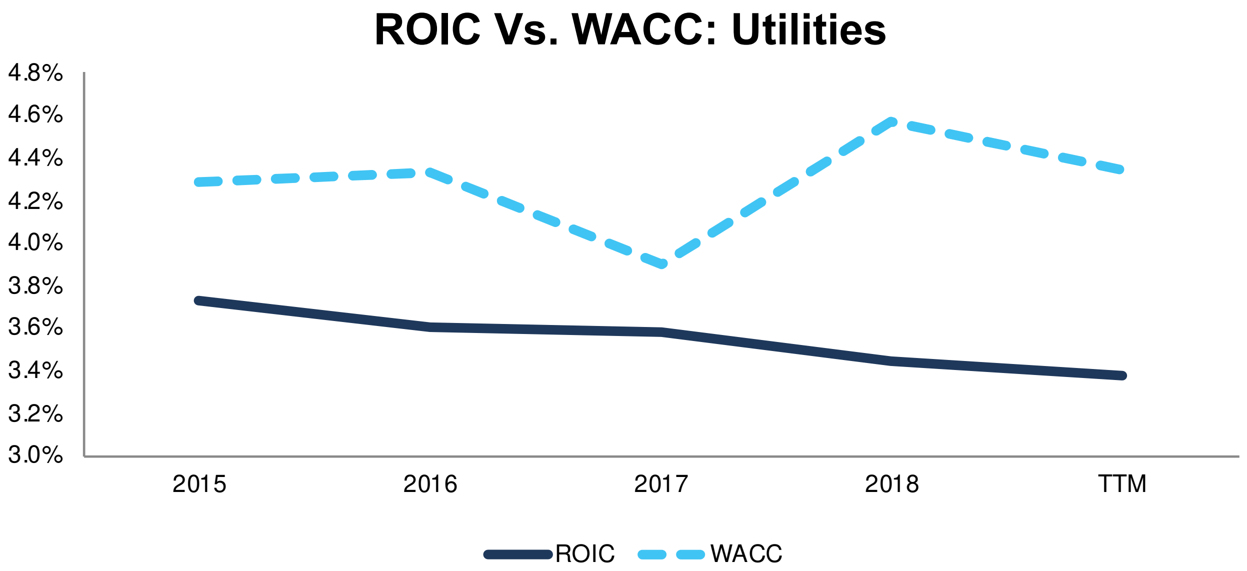


Sources: New Constructs, LLC and company filings.

Utilities

The Utilities sector's 3.4% ROIC is the lowest of any sector. As Figure 11 shows, it has also steadily declined since 2015. Margins are gradually increasing, but capital turns are down from 0.27 in 2015 to 0.23 TTM. See the Appendices for analysis of ROIC vs WACC, NOPAT margins and invested capital turns back to 1998.

Figure 12: Utilities ROIC vs. WACC: 2015-TTM



Sources: New Constructs, LLC and company filings.

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

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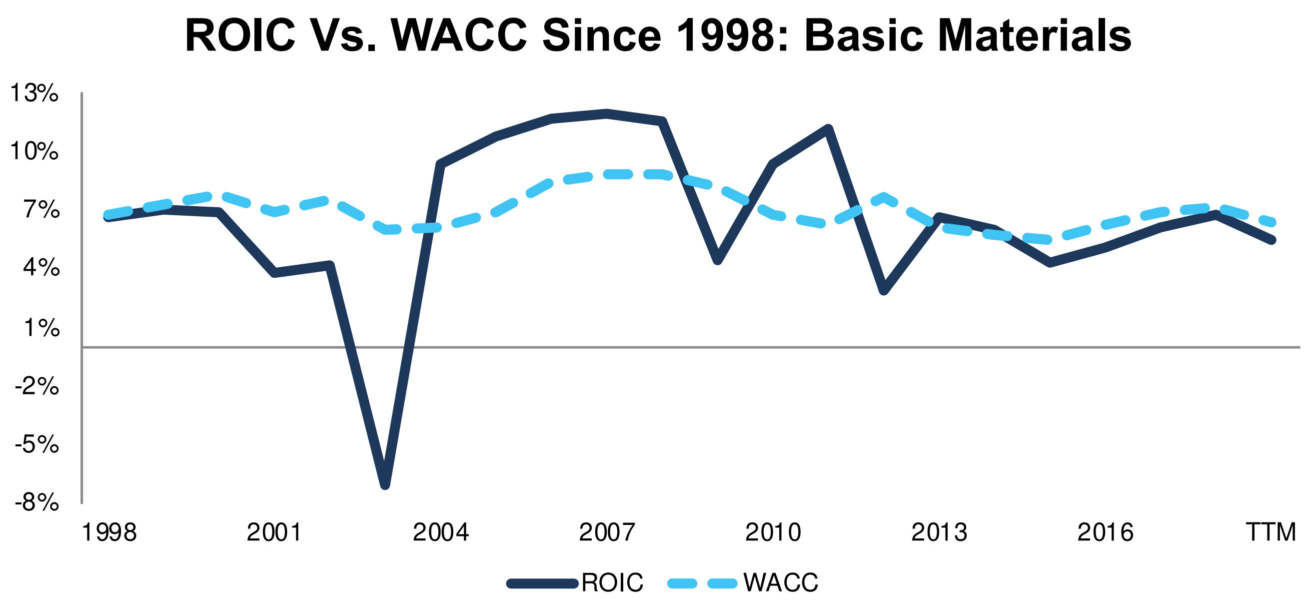
Appendix I: ROIC and WACC Since 1998

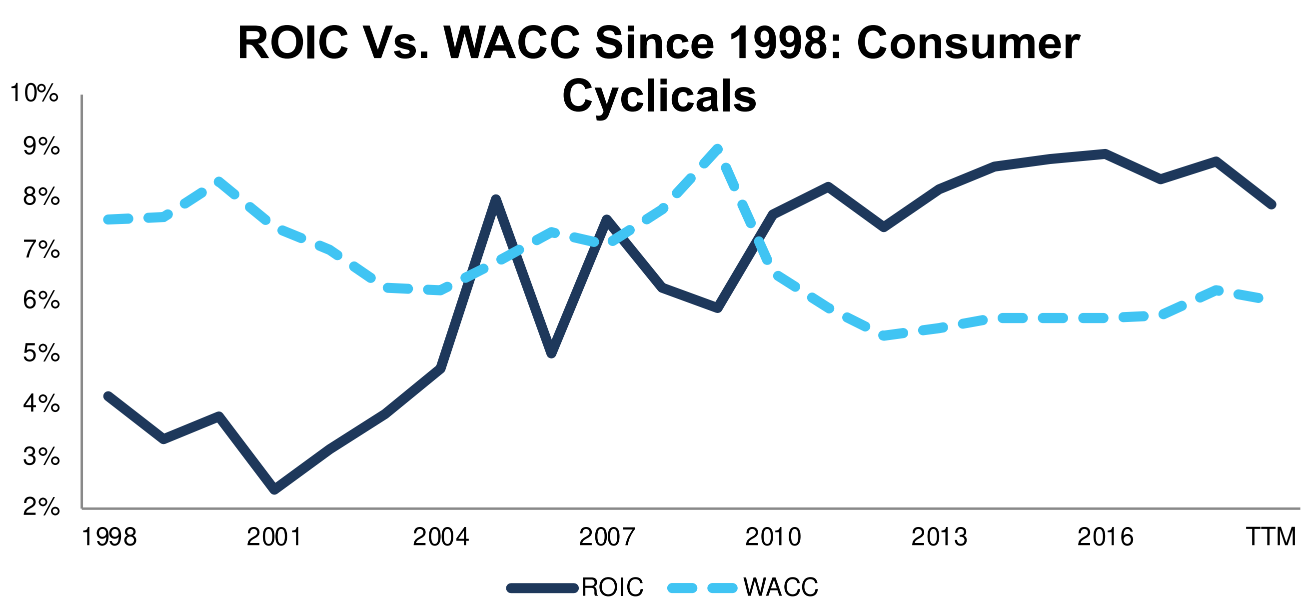
The body of this report showed ROIC vs. WACC since 2015 so investors could more clearly see recent trends. This appendix shows the data going back to 1998 so that investors can better understand the long-term trajectory of each sector.

Figure 13: Basic Materials ROIC Vs. WACC: 1998 to present



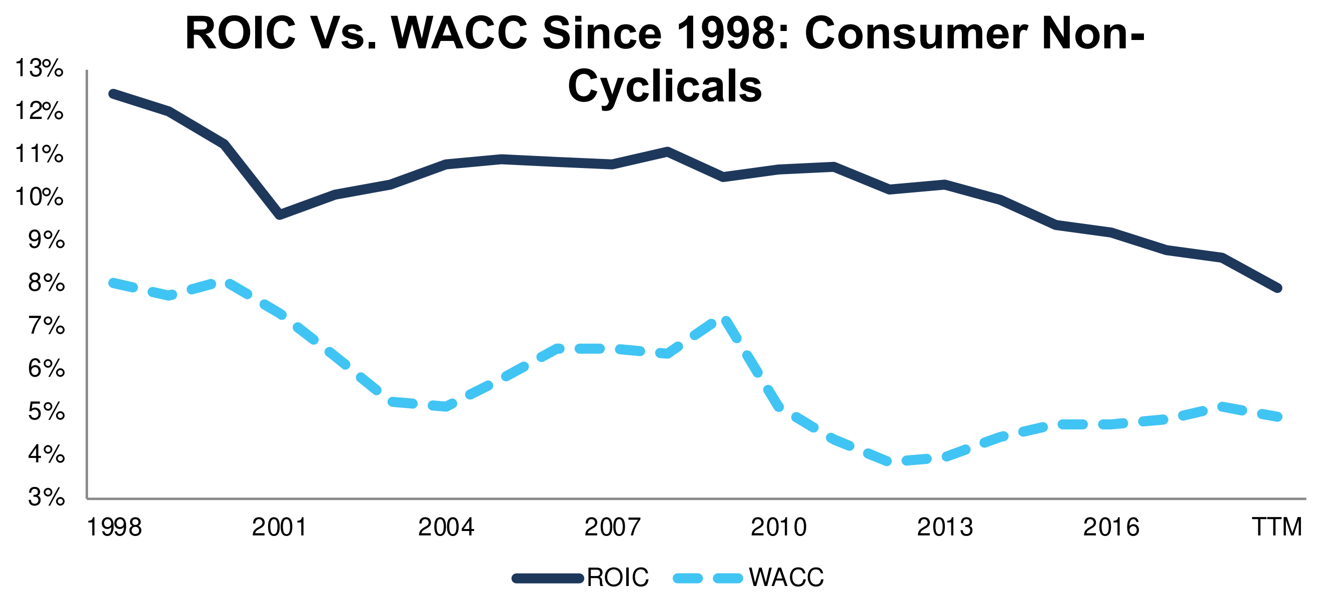
Sources: New Constructs, LLC and company filings.

Figure 14: Consumer Cyclicals ROIC Vs. WACC: 1998 to present



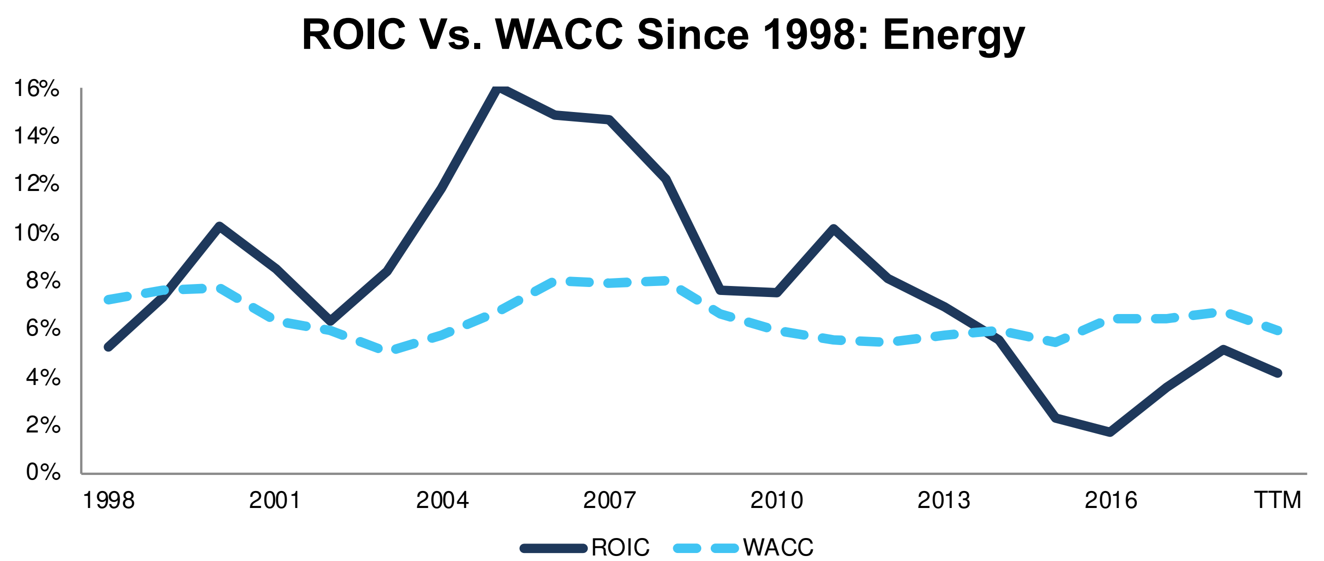
Sources: New Constructs, LLC and company filings.

Figure 15: Consumer Non-Cyclicals ROIC Vs. WACC: 1998 to present



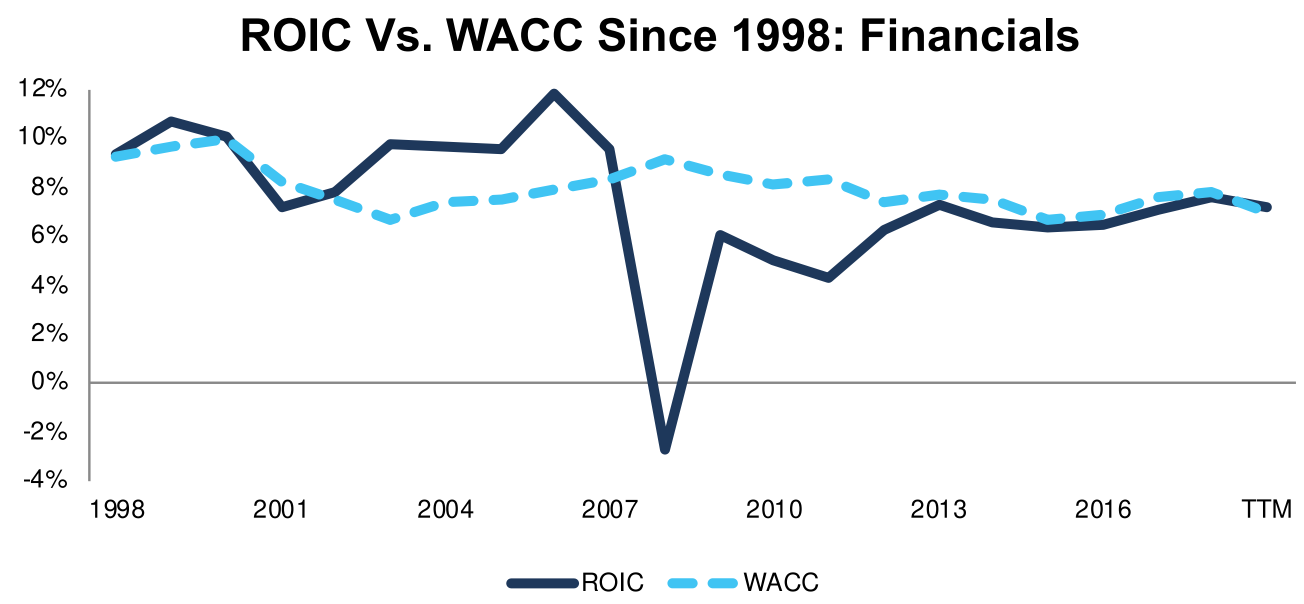
Sources: New Constructs, LLC and company filings.

Figure 16: Energy ROIC Vs. WACC: 1998 to present



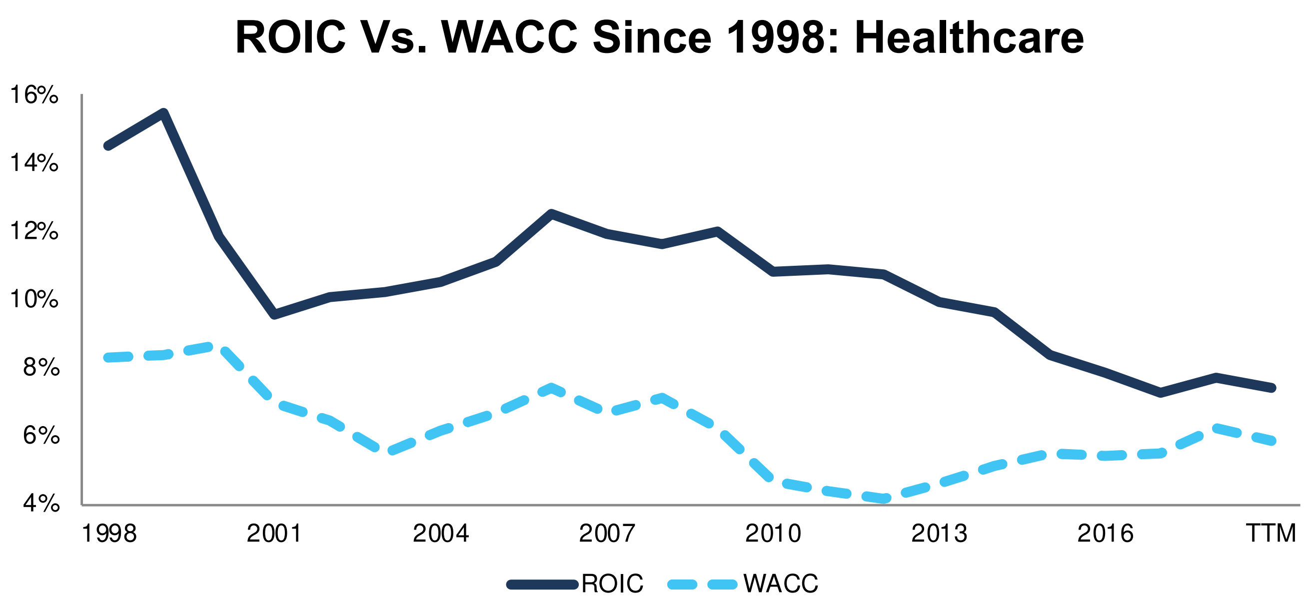
Sources: New Constructs, LLC and company filings.

Figure 17: Financials ROIC Vs. WACC: 1998 to present



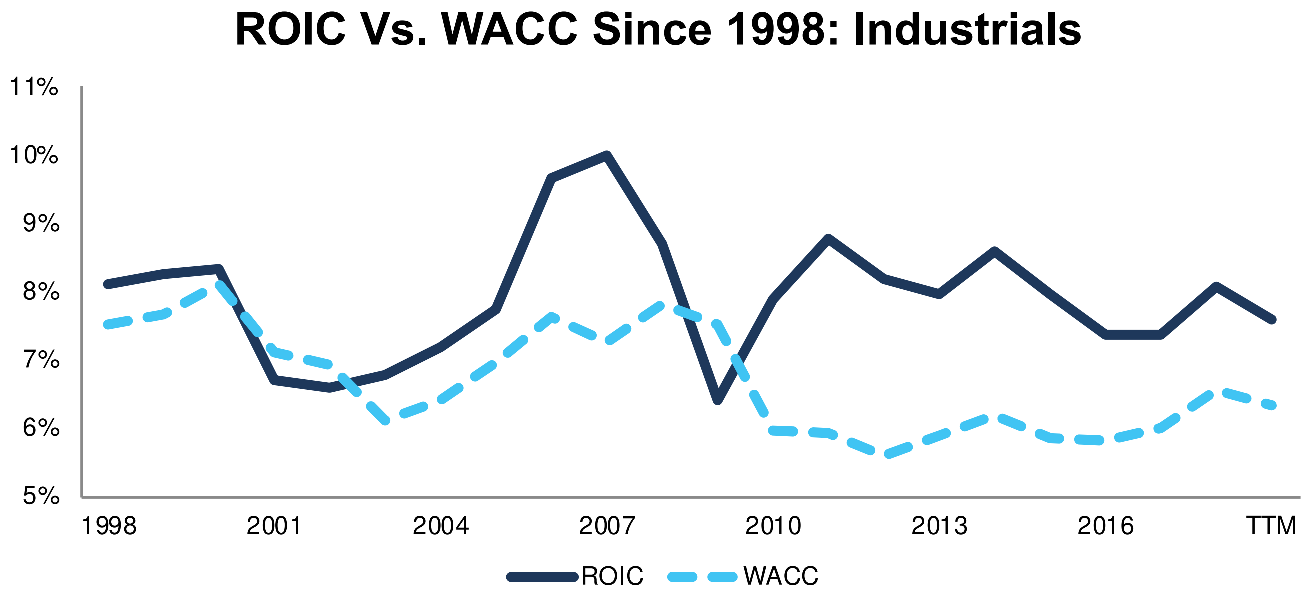
Sources: New Constructs, LLC and company filings.

Figure 18: Healthcare ROIC Vs. WACC: 1998 to present



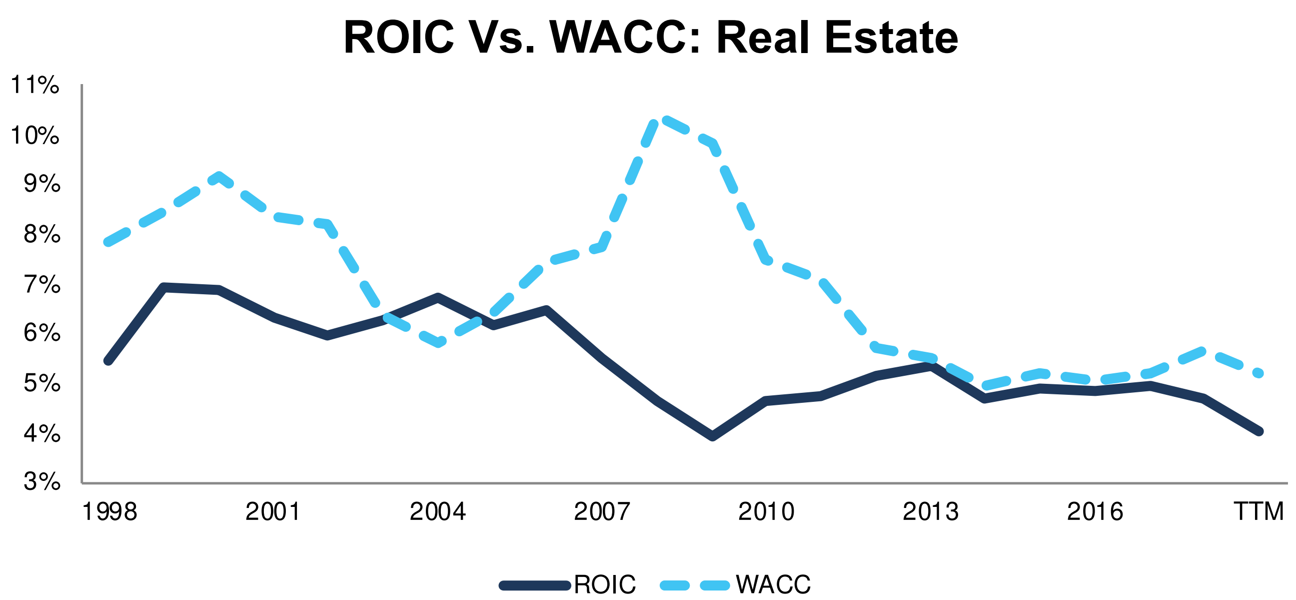
Sources: New Constructs, LLC and company filings.

Figure 19: Industrials ROIC Vs. WACC: 1998 to present



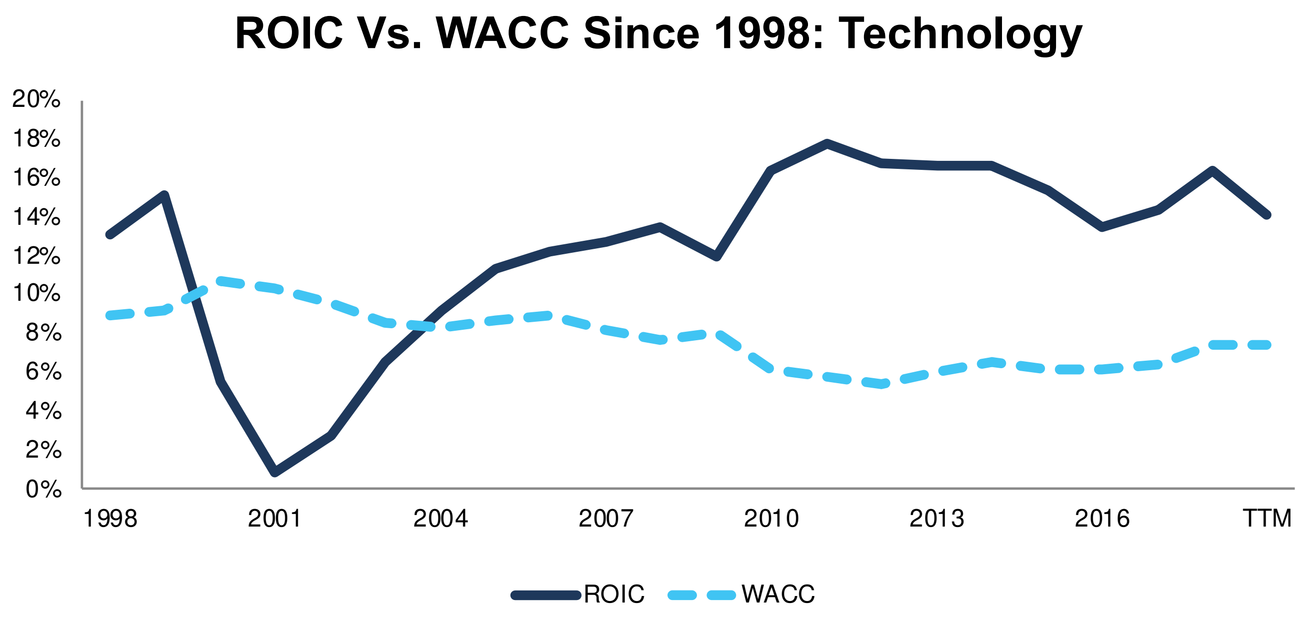
Sources: New Constructs, LLC and company filings.

Figure 20: Real Estate ROIC Vs. WACC: 1998 to present



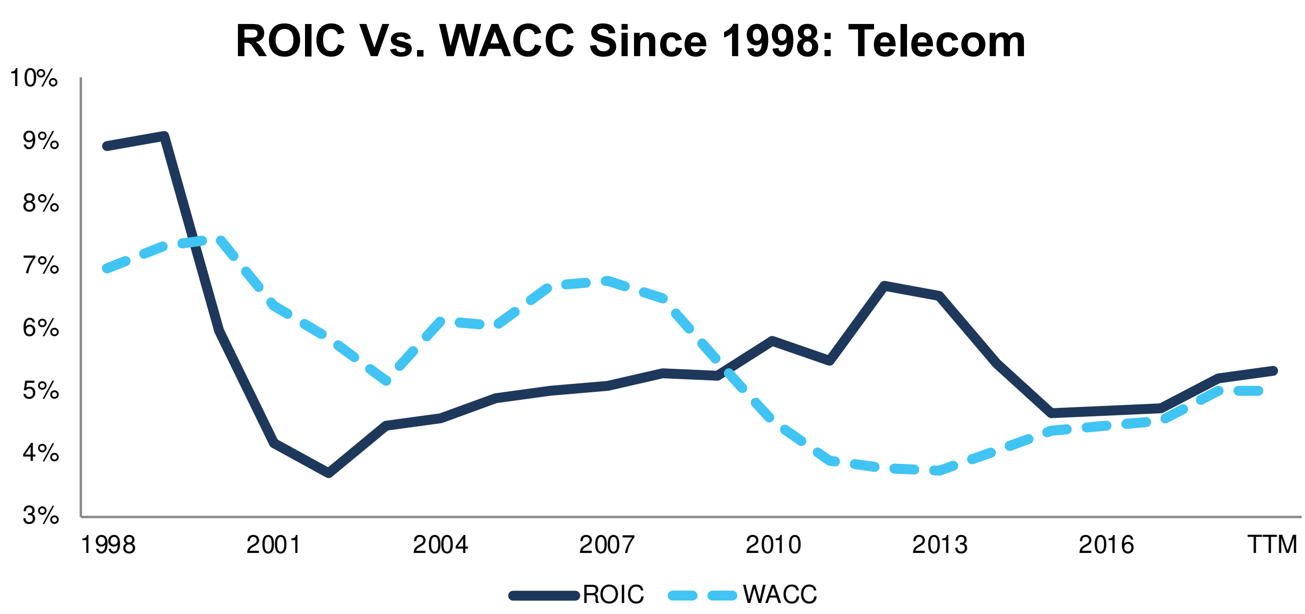
Sources: New Constructs, LLC and company filings.

Figure 21: Technology ROIC Vs. WACC: 1998 to present



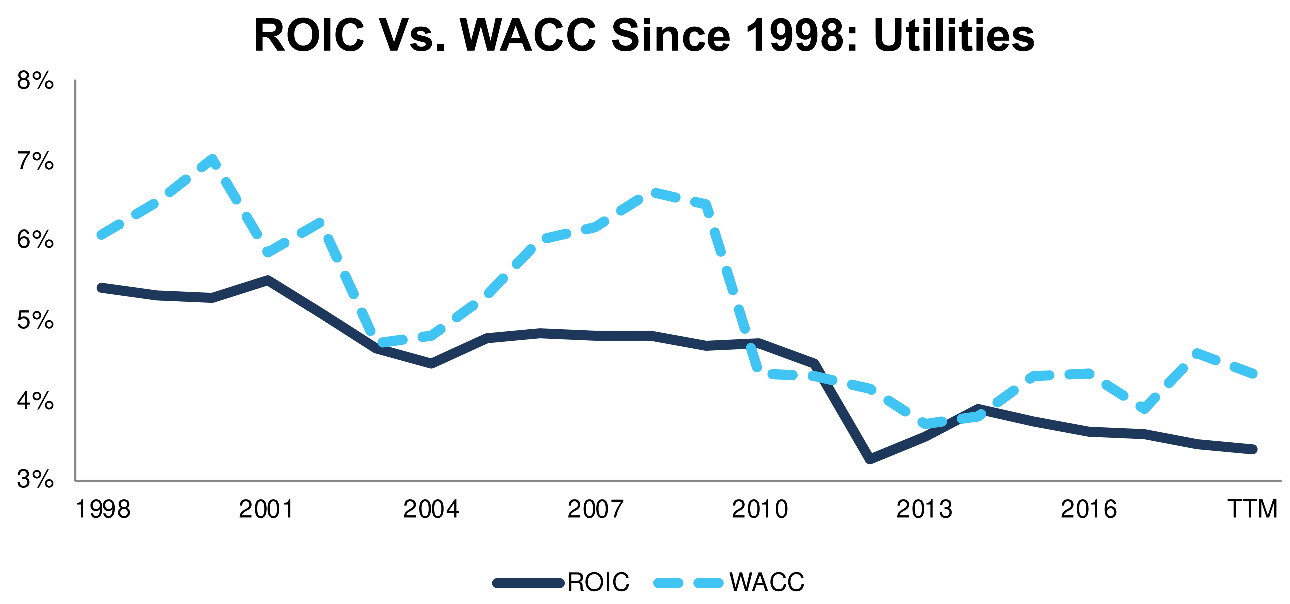
Sources: New Constructs, LLC and company filings.

Figure 22: Telecom ROIC Vs. WACC: 1998 to present



Sources: New Constructs, LLC and company filings.

Figure 23: Utilities ROIC Vs. WACC: 1998 to present



Sources: New Constructs, LLC and company filings.

Appendix II: NOPAT Margin and Invested Capital Turns Since 1998

This appendix shows the two (DuPont model) drivers of ROIC – NOPAT margin and invested capital turns – for each sector going back to 1998. For more information on how we calculate these drivers of ROIC, see here.

Figure 24 ranks all 11 sectors by TTM NOPAT margin.

Figure 24: TTM NOPAT Margin by Sector

Sector	NOPAT Margin	Rank
Real Estate	18.3%	1st
Utilities	14.8%	2
Financials	14.2%	3
Technology	14.2%	4
Telecom	12.6%	5
Basic Materials	9.5%	6
Industrials	9.1%	7
Healthcare	8.9%	8
Energy	7.2%	9
Consumer Cyclicals	6.8%	10
Consumer Non-cyclicals	5.8%	11th

Sources: New Constructs, LLC and company filings.

Figure 25 ranks all 11 sectors by TTM average invested capital turns.

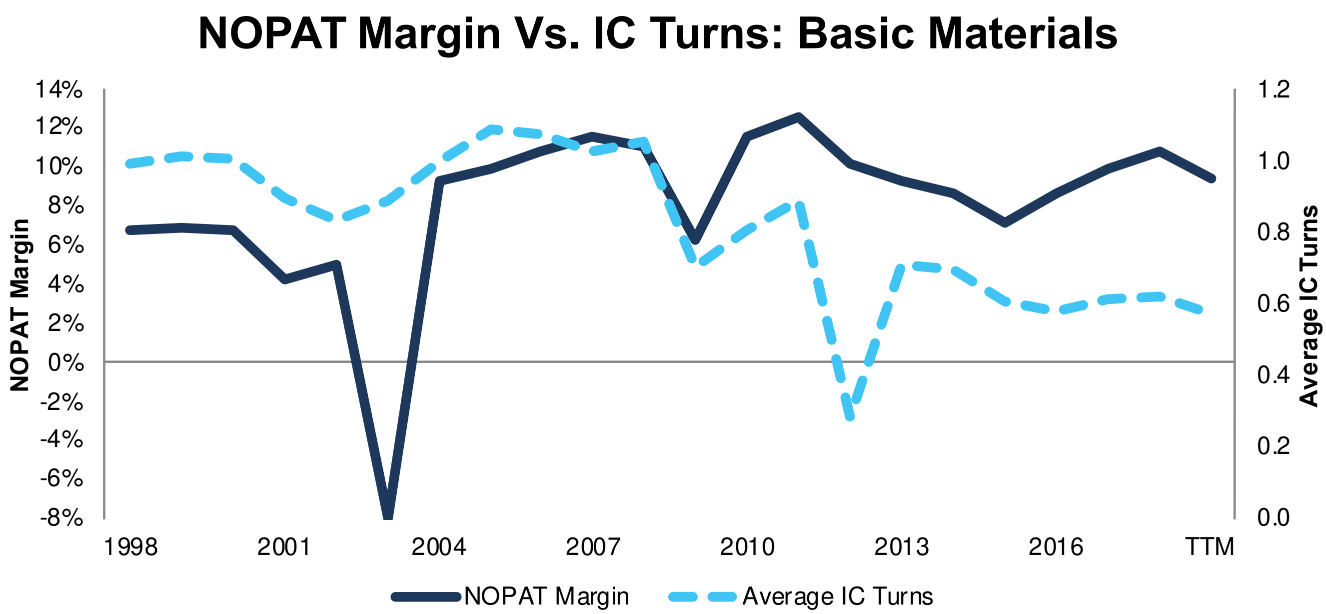
Figure 25: TTM Average Invested Capital Turns by Sector

Sector	Average Invested Capital Turns	Rank
Consumer Non-cyclicals	1.37	1st
Consumer Cyclicals	1.17	2
Technology	0.99	3
Healthcare	0.84	4
Industrials	0.83	5
Energy	0.58	6
Basic Materials	0.57	7
Financials	0.50	8
Telecom	0.42	9
Utilities	0.23	10
Real Estate	0.22	11th

Sources: New Constructs, LLC and company filings.

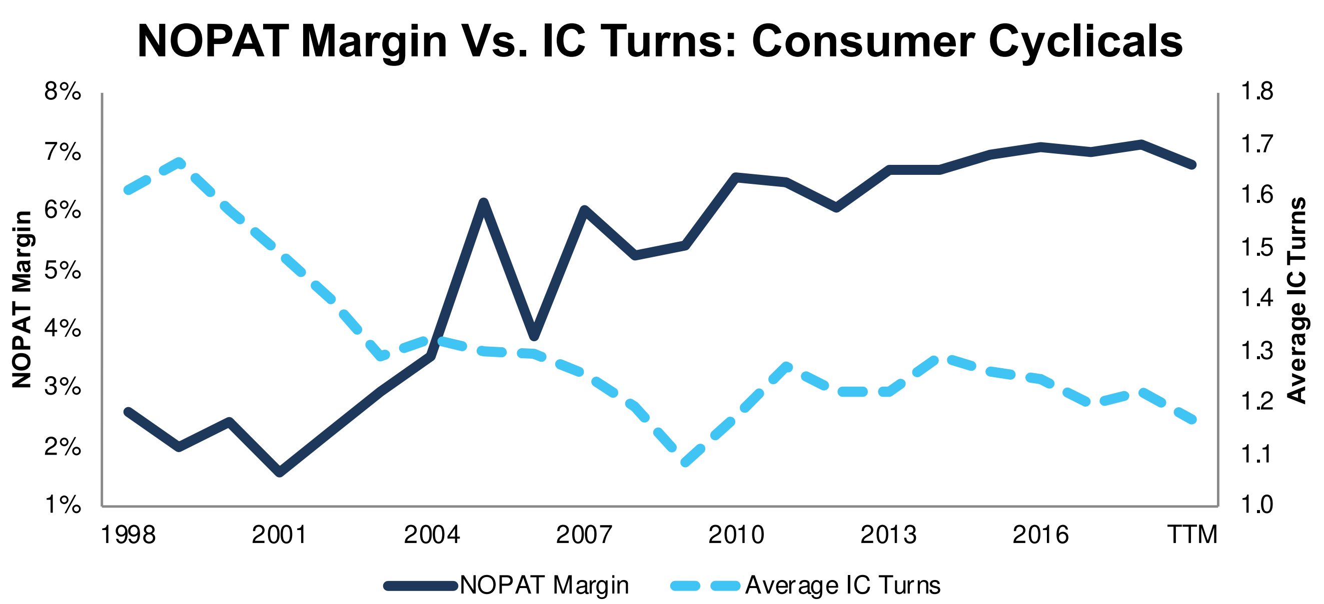
These two tables show how rare it is for a sector to have both high margins and capital turns. Real Estate, the highest margin sector, has the worst capital turns. Consumer Non-cyclicals, the highest capital turns sector, has the lowest margins. Only the Technology sector is above average in both margins and capital turns, which is why that sector leads the market in ROIC by a wide margin.

Figure 26: Basic Materials NOPAT Margin and IC Turns: 1998 to present



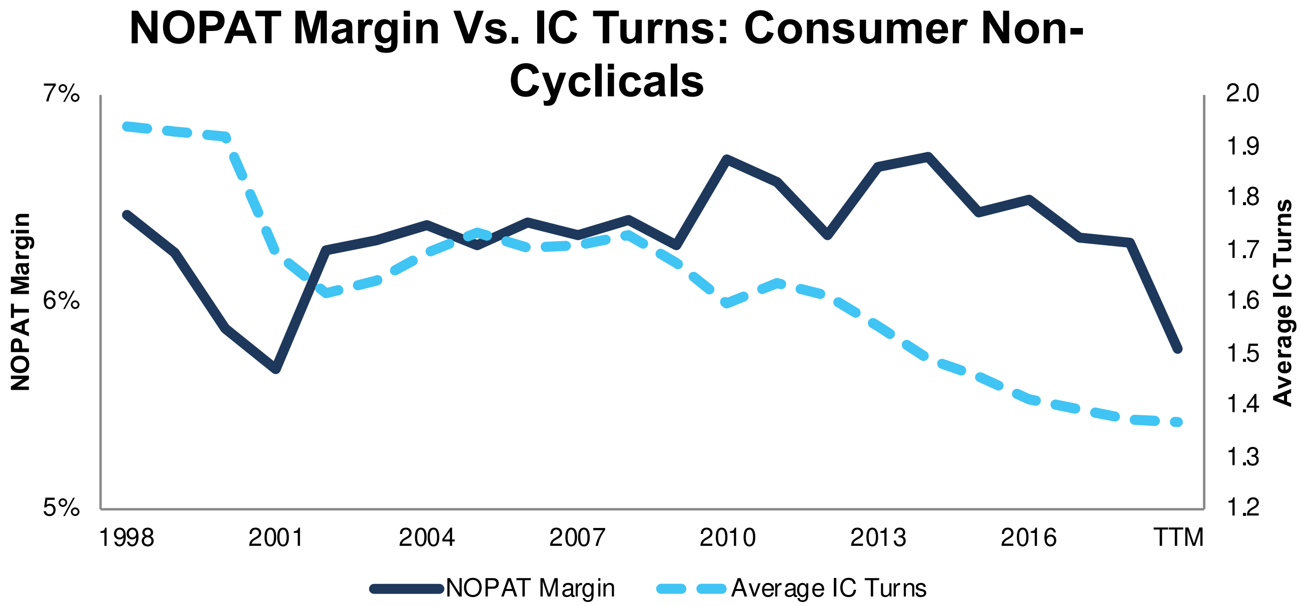
Sources: New Constructs, LLC and company filings.

Figure 27: Consumer Cyclicals NOPAT Margin and IC Turns: 1998 to present



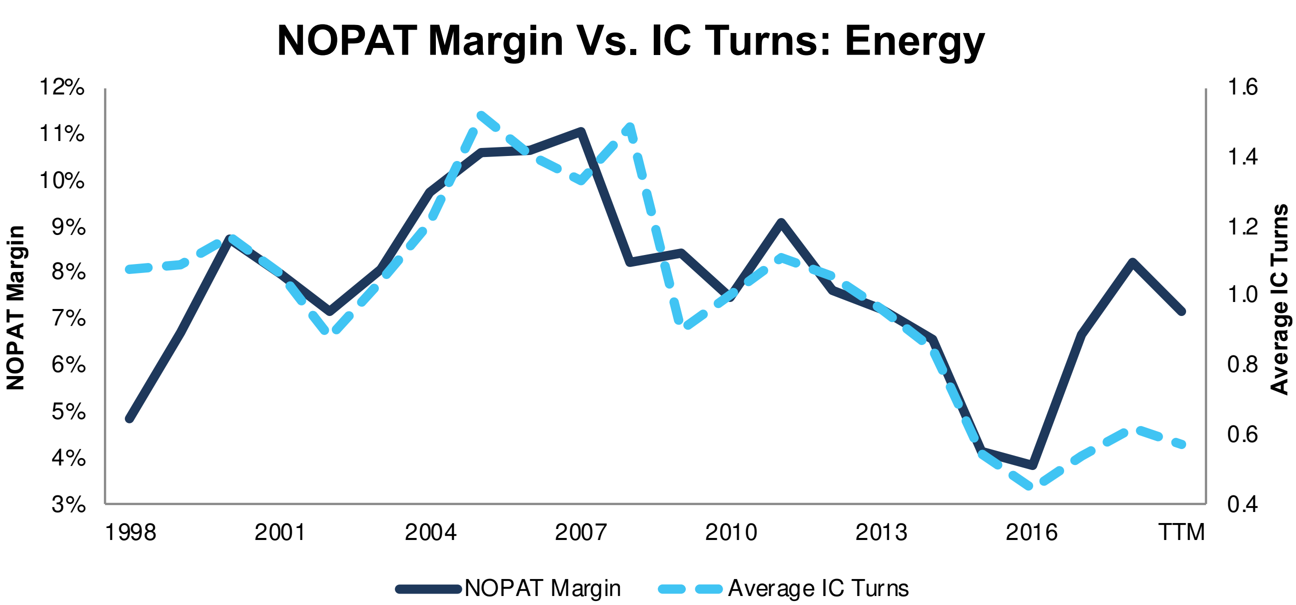
Sources: New Constructs, LLC and company filings.

Figure 28: Consumer Non-Cyclicals NOPAT Margin and IC Turns: 1998 to present



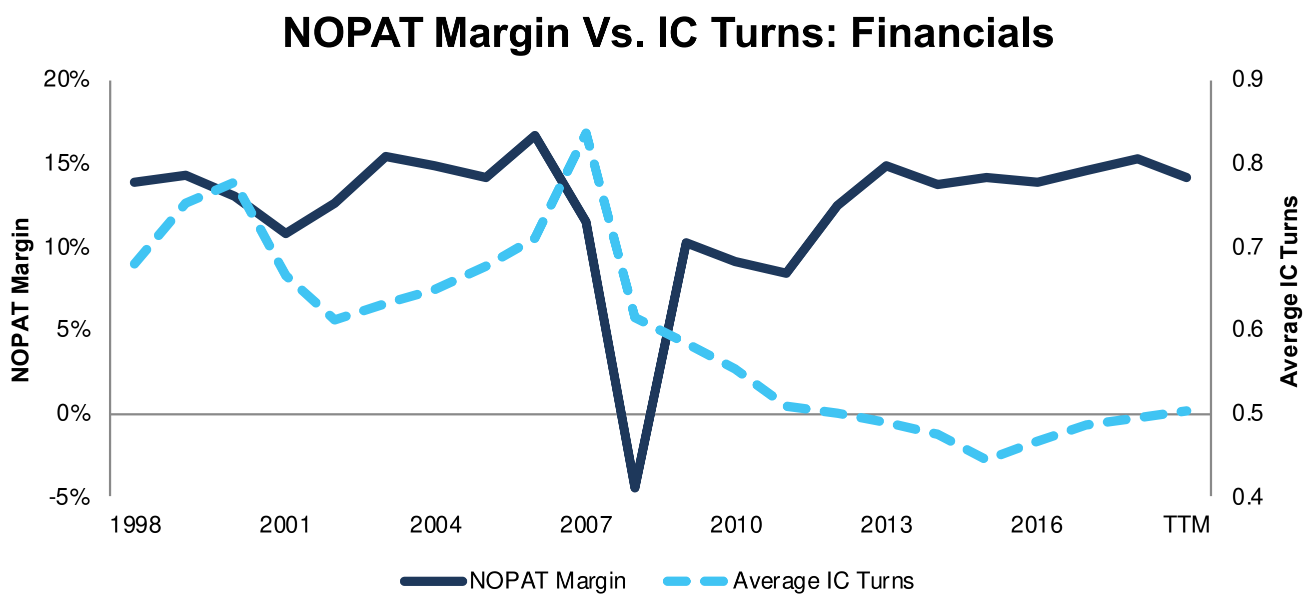
Sources: New Constructs, LLC and company filings.

Figure 29: Energy NOPAT Margin and IC Turns: 1998 to present



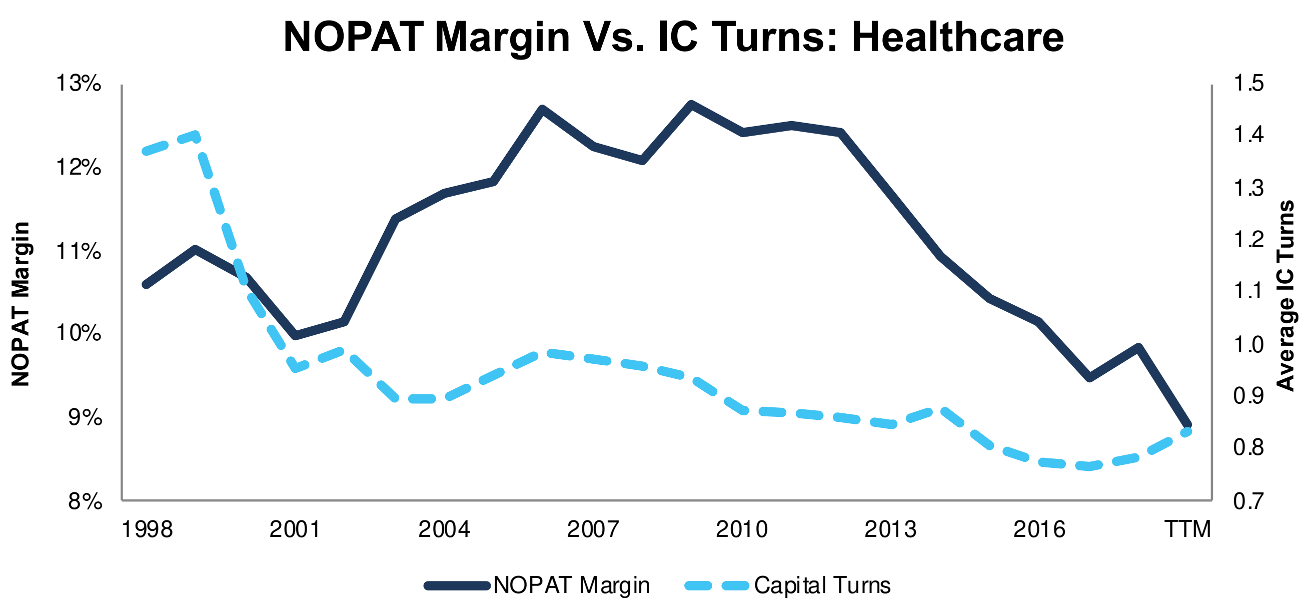
Sources: New Constructs, LLC and company filings.

Figure 30: Financials NOPAT Margin and IC Turns: 1998 to present



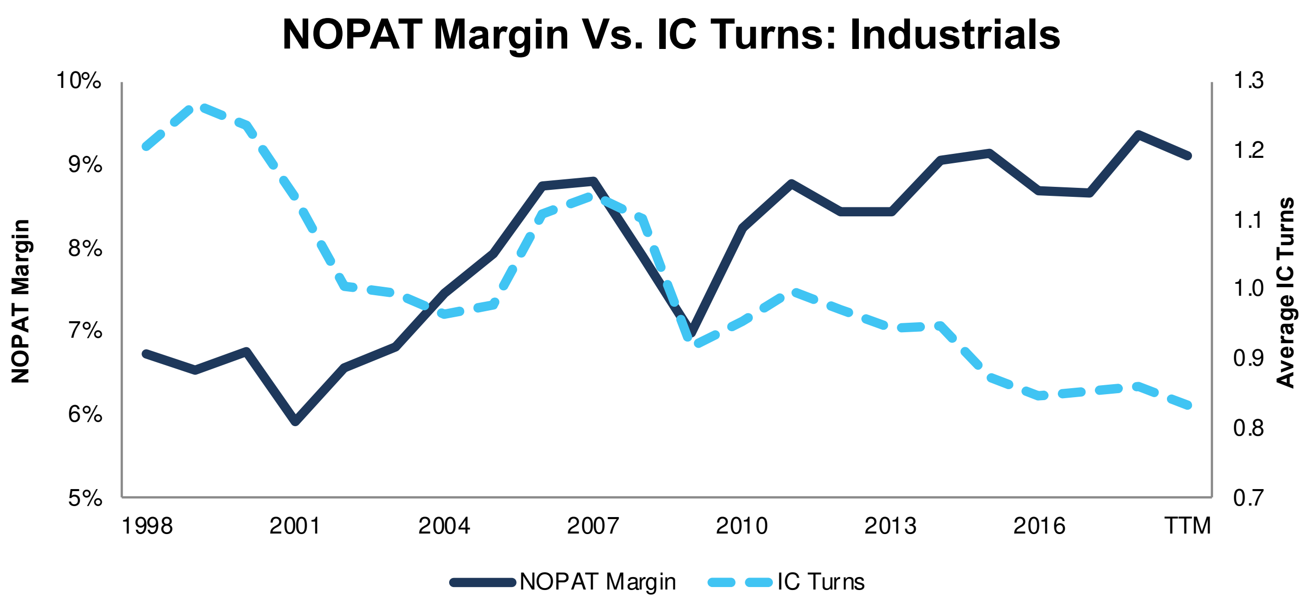
Sources: New Constructs, LLC and company filings.

Figure 31: Healthcare NOPAT Margin and IC Turns: 1998 to present



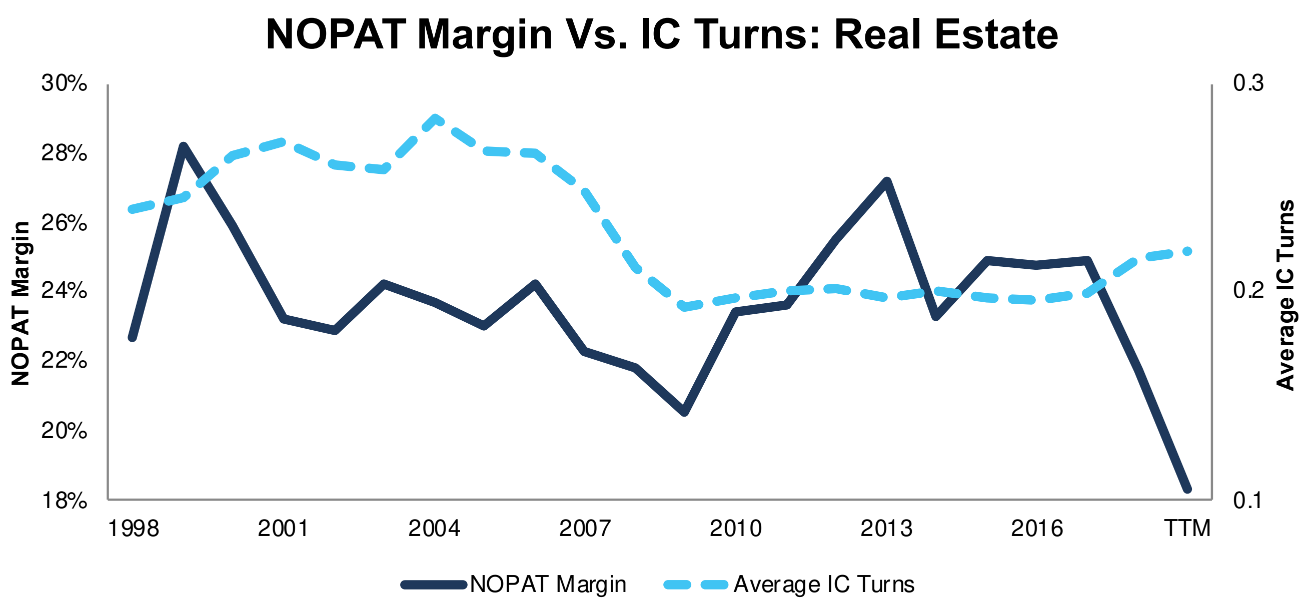
Sources: New Constructs, LLC and company filings.

Figure 32: Industrials NOPAT Margin vs. IC Turns: 1998 to present



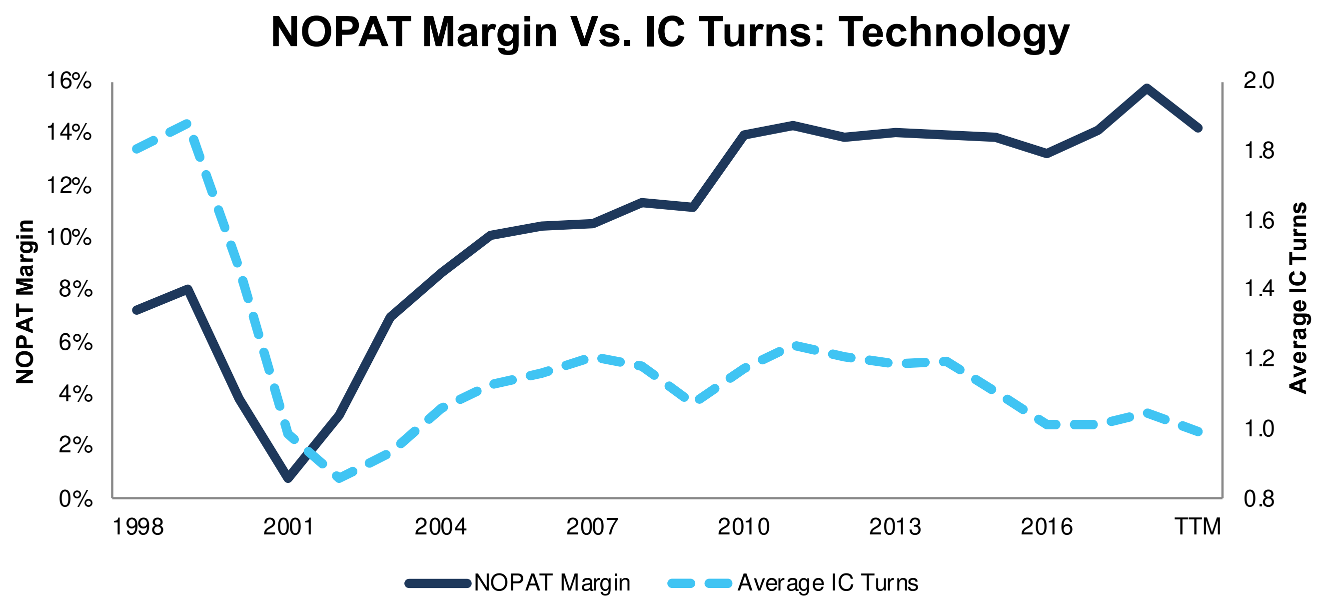
Sources: New Constructs, LLC and company filings.

Figure 33: Real Estate NOPAT Margin Vs. IC Turns: 1998 to present



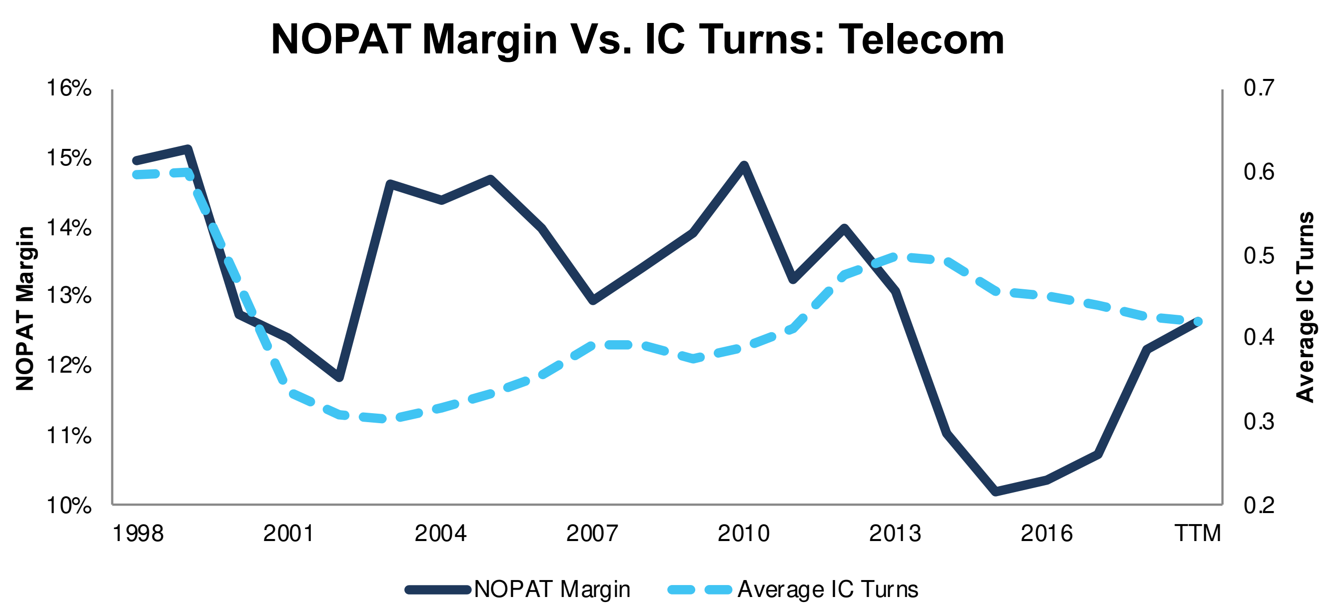
Sources: New Constructs, LLC and company filings.

Figure 34: Technology NOPAT Margin Vs. IC Turns: 1998 to present



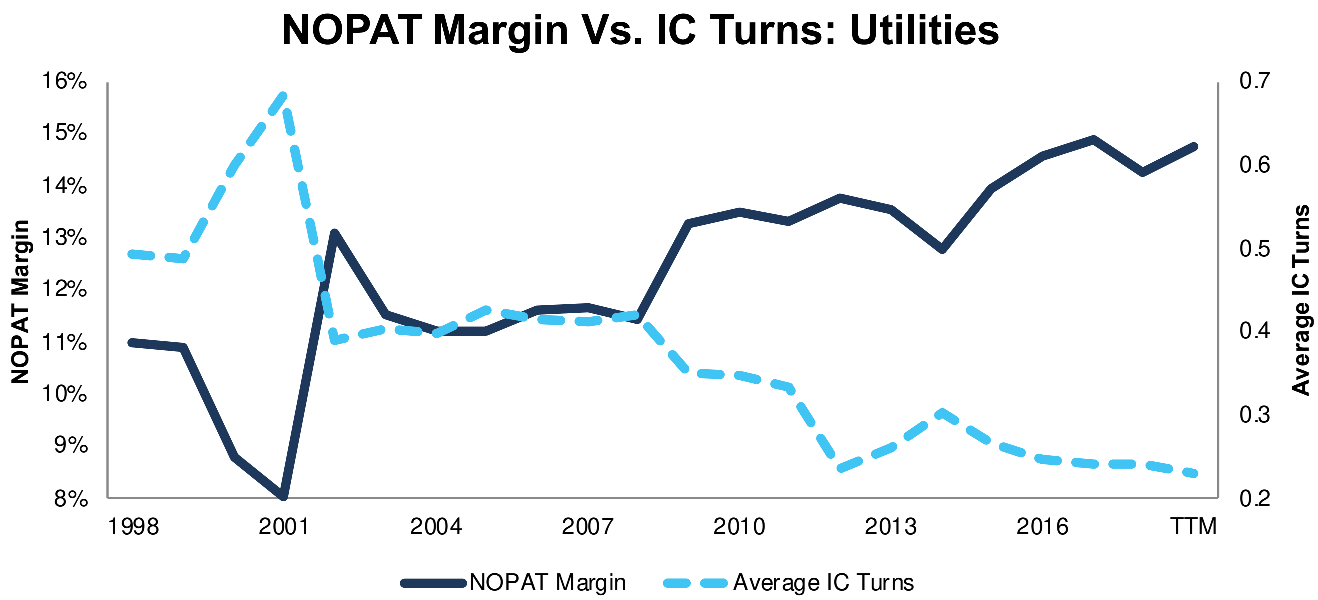
Sources: New Constructs, LLC and company filings.

Figure 35: Telecom NOPAT Margin Vs. IC Turns: 1998 to present



Sources: New Constructs, LLC and company filings.

Figure 36: Utilities NOPAT Margin vs. IC Turns: 1998 to present



Sources: New Constructs, LLC and company filings.

Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

HBS & MIT Sloan research reveals that:

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- **Corporate managers hide gains/losses in footnotes to manage earnings.**
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The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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