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Albert Richards launched Alambic Investment Management, L.P. in 2006, with over 20-years of equity research experience and a lifetime technical acumen. Bert and Brian Thompson, Bert's longtime friend and colleague from the PhD program at MIT, started the firm to bring thoughtful human insights to the design, development and operation of systematic investment strategies. Now with a 6-year track record, the team launched their first product, an equity market neutral hedge fund in 2011.

Before starting Alambic Investment Management, Bert perfected the art of tearing apart financial statements to find value and opportunity. As a sell-side analyst and head of research within two large global investment banks, Bert became adept at identifying and quantifying the key drivers of equity valuation and company quality as well as the behavioral pitfalls that create market opportunities.

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Alambic Insights:

Why You May (Eventually) Lose a Lot of Money in Tech

In his 2016 letter to investors, Warren Buffet dedicated a few lines to this concern: "Too many managements - and the number seems to grow every year - are looking for any means to report, and indeed feature, "adjusted earnings" that are higher than their company's GAAP earnings. There are many ways for practitioners to perform this legerdemain. Two of their favorites are the omission of "restructuring costs" and "stock-based compensation" as expenses."

The difference between pro forma and GAAP can be benign or deceptive, but the only way to know is to dive into the details. Whatever the amount or source of the difference between GAAP and pro forma, earnings (or EBITDA) it is not possible to judge the relative value of two companies without measuring them on level footing.

At Alambic, our systematic process reaches beyond the "headline" numbers and drills down into cash flows, debt levels, trends, intrinsic values, etc. Our belief, supported by history and statistics, is that investors tend to overreact to headlines and headline numbers without sufficiently parsing the financial statements. Alambic's proprietary models dig deep into current and historical financial statements where they sometimes find support for investor trends and sometimes find opportunities to bet against them. Every day, our process identifies stocks that it considers slightly mispriced, and which we believe to be arbitrage opportunities that can be profitably harvested by patient, systematic investors with a valuation-based approach, like ours.

But, the economy is strong and earnings great, what could possibly go wrong?

As Buffet suggests, the increasingly-widespread use of adjusted earnings can, in combination with employee stock grants and stock repurchases, create the impression of a successful company where in fact none exists. To be fair, many of the adjustments companies add back to earnings do indeed give a better general overview of the company's operations over the period by eliminating several one-off or temporary items. But adding back stock compensation is, in our opinion, just plain wrong.

We can illustrate the problem with a simple fictitious example. Let's suppose that a Wall Street whiz kid turned tech CEO, is running a company that makes no money. For the purpose of the illustration, we'll call him Addison. A company that makes no money could be a somewhat difficult sell to investors, and Addison has stock options that create incentive for him to get the share price up. Fortunately, Addison has a wonderful idea: he will substitute $100 million in cash employee compensation with payment in stock.

With this substitution, Addison saves $100 million in the company's bank account over the course of the year. Economically, this is the same as a issuing shares – Addison could just as easily have paid the employees in cash and sold $100 million in stock to arrive at the same economic place. But the financial accounting is meaningfully different. "Share-based compensation" can be put into "cash from operating activities" as opposed to "equity financing" and thereby contribute to positive cash flow. The numbers involved can be quite significant – Facebook, for example, boosted operating cash flow by over $2.1 billion with this line item in the first 6 months of 2018.

Share-based compensation is not only (incorrectly) counted as operating cash flow, but it is also frequently added back to earnings as an adjustment. Addison's company still makes no money, and GAAP earnings are still zero, but "adjusted" earnings are $100 million! Not only that, but Addison can "grow" adjusted earnings just by giving employees more stock. How weird and economically counter-intuitive is that?

What does Addison's fictitious company do with its new-found $100 million in cash? It could, of course, invest it, creating "growth", but not growth that necessarily benefits shareholders because the share count has also increased. But investing is hard, and it's often not successful – particularly for a (fictitious) ex-Wall Street executive who doesn't really understand the company's technology anyway.

So instead of investing, Addison jumps onto the other current financial craze – share buybacks. The company simply buys back $100 million in stock to cover the $100 million in stock that was granted to the employees. Note that the company remains economically the same as it was when it started – it still makes no money, and shares outstanding are unchanged. But it is entitled to report $100 million in additional cash flow, plus $100 million in "adjusted earnings".

These share repurchases tend to boost the share price, as the employee's stock doesn't vest for 3 years so they can't be sellers. Hence for the moment the company represents an incremental buyer in the market, pushing up the share price. And voila, Addison's stock options are in the money.

Unfortunately, the game doesn't stop there because of some additional accounting slight-of-hand that occurs with taxes. This happens because the IRS doesn't allow Addison's company an immediate $100 million expense deduction when the employees are paid in stock because the stock itself hasn't vested yet. As a result, the "book" accounts (i.e., the ones in the 10-Q's and 10-K's) there is a $100 million expense which results in a $21 million reduction in "book" taxes. But on the tax accounts the expense isn't recognized, and thus the taxes paid are actually $21 million higher than those in the "book" accounts, this difference being recorded as a tax credit on the balance sheet.

Fast forward 3 years, and the employee's stock vests. What happens? If the stock is still worth $100 million, the employees report $100 million in income, and the tax credit is utilized, netting the company a $21 million refund against the tax credit. This is purely a balance sheet transaction, and earnings are not affected.

But what if the stock is worth $200 million? In this case the employees report $200 million in income, not $100 million. Economically, we would argue that the company should report an additional $100 million in expense, as that's what the stock was worth when it vested, but the Financial Accounting Standards Board (FASB) allows the company to simply ignore this additional cost. But the IRS does allow the full $200 million as an expense deduction on the "tax" books, as an equivalent amount is being reported by the employees as income. When this happens, the extra $100 million in expense creates an additional tax savings of $21 million. So how does the accounting work for this extra savings?

Prior to 2017, this additional $21 million in savings didn't flow through the income statement because the extra $100 million in expense wasn't there either. Instead, the "excess tax benefit" was simply added to shareholders' equity in the Adjusted Other Comprehensive Income line, or AOCI. But, beginning last year, the FASB allowed companies to flow this extra tax saving through the income statement. This creates the bizarre situation where a company gets to report extra income, as opposed to extra expenses, when the value of employee stock compensation increases.

In this scenario, Addison would be a very happy camper. The hypothetical company still makes no money, but it reports $100 million in extra operating cash flow, and $100 million in "adjusted" earnings, earnings that only grow the more stock Addison gives away. And if the share price is up when the employee stock vests, even more income is reported (this time even under GAAP) because of the ability of the company to report only the additional tax savings, but not the additional stock expense due to the higher stock price.

So why does this mean you may (eventually) lose a lot of money in Tech? Because, if you look around, there are a lot of real companies out there like Addison's. They make no money, but they create the illusion of cash flow, earnings, and growth through the use not only of non-GAAP adjustments but also through the absurdity of GAAP rules when it comes to share-based compensation – both where the financing is reported (in "cash from operations") and how the higher expenses and tax savings therefrom are accounted for when the employee stock vests. Indeed, these companies can even be losing money, but they can continue as going concerns through effectively financing themselves by what is, in effect, issuing shares to their employees.

How long Addison's company can keep going therefore depends on investors' faith. As long as they're willing to buy the company's shares in the hopes that Addison eventually manages to find something the makes the company profitable, nothing changes, and the share price likely continues to climb. But when that eventual downturn does arrive, investors will likely increase their financial scrutiny at the same point that Addison's break-even business becomes a cash flow negative operation in need of external financing. This could well finish ugly.

We certainly don't want to give the impression that we're down on Tech in general. There are clearly some great companies out there, with fantastic products that are disruption entire markets. But there are also a lot of Addison's out there, and these companies could be the source of a lot of pain when the next downturn does arrive. Be careful out there!

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