Pro-Forma Earnings vs. GAAP in Merger Models: What Really Matters?

And what's wrong with GAAP, anyway?

Pro-Forma Earnings vs. GAAP

*"What is the **significance** of the 'Pro-Forma Earnings' and 'Pro-Forma EPS' and 'Pro-Forma Accretion/Dilution' you calculate in merger models?"*

"What do they mean, and how do bankers use these metrics to advise clients?"

Pro-Forma Earnings vs. GAAP

- **SHORT ANSWER:** Pro-Forma Earnings always make a company's results look better by **removing** certain expenses, and they let bankers argue in favor of marginal-to-poor deals

- **Typical:** Remove restructuring costs, amortization of intangibles, legal settlement costs, asset impairments, gains/losses… and sometimes even stock-based compensation!

- **M&A Scenario:** You typically add back new depreciation & amortization on asset-writeups; sometimes also restructuring / integration costs and deferred revenue write-downs

- **So:** How much of a difference does this make?

Example 1: Merck

- **Massive** difference! The Company's "non-GAAP EPS" is more than double its GAAP EPS!

$ in millions, except EPS amounts	Fourth Quarter 2016	Fourth Quarter 2015
EPS		
GAAP EPS	$0.42	$0.35
Difference [4]	0.47	0.58
Non-GAAP EPS that excludes items listed below [1]	$0.89	$0.93
Net Income		
GAAP net income [2]	$1,177	$976
Difference	1,293	1,632
Non-GAAP net income that excludes items listed below [1,2]	$2,470	$2,608
Decrease (Increase) in Net Income Due to Excluded Items:		
Acquisition- and divestiture-related costs [3]	$780	$1,264
Restructuring costs	310	340
Charge to settle worldwide KEYTRUDA patent litigation	625	—
Net charge to settle Vioxx shareholder class action litigation	—	680
Foreign exchange losses related to Venezuela	—	161
Gain on divestiture of certain ophthalmic products	—	(147)
Gain on divestiture of certain migraine clinical development programs	—	—
Other	29	13
Net decrease (increase) in income before taxes	1,744	2,311
Income tax (benefit) expense [5]	(451)	(679)
Decrease (increase) in net income	$1,293	$1,632

Example 2: Starbucks / Krispy Kreme Deal

- **Almost no difference** because the adjustments in this M&A deal are all small (minimal new amortization, depreciation, etc.):

		Projected - Combined Period:				
Combined Income Statement:	***Units:***	**FY16**	**FY17**	**FY18**	**FY19**	**FY20**
Acquirer - Standalone EPS:	*$ / Share*		$ 1.99	$ 2.22	$ 2.42	$ 2.62
Earnings Per Share (EPS):	*$ / Share*		**$ 2.00**	**$ 2.23**	**$ 2.44**	**$ 2.64**
Accretion / (Dilution) - $:	*$ / Share*		$ 0.01	$ 0.01	$ 0.02	$ 0.03
Accretion / (Dilution) - %:	*%*		0.4%	0.5%	0.7%	1.0%
Pro-Forma Earnings Per Share (EPS):	*$ / Share*		**$ 2.00**	**$ 2.24**	**$ 2.44**	**$ 2.65**
Pro-Forma Accretion / (Dilution) - $:	*$ / Share*		$ 0.01	$ 0.02	$ 0.02	$ 0.03
Pro-Forma Accretion / (Dilution) - %:	*%*		0.7%	0.8%	0.9%	1.2%

Pro-Forma Earnings vs. GAAP

- "Pro-Forma" or "Non-GAAP" or "Adjusted" or "Operating" earnings in M&A deals make the **biggest difference** when…

- **Condition #1:** The deal is "**borderline**" accretive/dilutive, and removing a few expenses could flip it

- **Condition #2:** The normal acquisition-related expenses, such as amortization of intangibles, are **significant** portions of pre-tax income (e.g., more than a few percentage points)

- **Condition #3:** OR there are **other** significant expenses, such as restructuring or integration costs on the Income Statement, that you're also removing

Real-Life Usage

- **Suppose** that amortization of intangibles were much bigger for this Starbucks / Krispy Kreme deal…

Intangible Asset Write-Up:	
Purchase Price to Allocate:	$ 1,100.1
% Allocated to Indefinite-Lived Intangibles:	30.0%
Indefinite-Lived Intangibles:	330.0
% Allocated to Definite-Lived Intangibles:	5.0%
Intangibles Write-Up Amount:	55.0
Amortization Period (Years):	5
Annual Amortization:	11.0

Intangible Asset Write-Up:	
Purchase Price to Allocate:	$ 1,100.1
% Allocated to Indefinite-Lived Intangibles:	30.0%
Indefinite-Lived Intangibles:	330.0
% Allocated to Definite-Lived Intangibles:	30.0%
Intangibles Write-Up Amount:	330.0
Amortization Period (Years):	5
Annual Amortization:	66.0

Combined Income Statement:	Units:	Projected - Combined Period: FY16	FY17	FY18	FY19	FY20
Acquirer - Standalone EPS:	$ / Share		$ 1.99	$ 2.22	$ 2.42	$ 2.62
Earnings Per Share (EPS):	$ / Share		**$ 2.00**	**$ 2.23**	**$ 2.44**	**$ 2.64**
Accretion / (Dilution) - $:	$ / Share		$ 0.01	$ 0.01	$ 0.02	$ 0.03
Accretion / (Dilution) - %:	%		0.4%	0.5%	0.7%	1.0%
Pro-Forma Earnings Per Share (EPS):	$ / Share		**$ 2.00**	**$ 2.24**	**$ 2.44**	**$ 2.65**
Pro-Forma Accretion / (Dilution) - $:	$ / Share		$ 0.01	$ 0.02	$ 0.02	$ 0.03
Pro-Forma Accretion / (Dilution) - %:	%		0.7%	0.8%	0.9%	1.2%

Combined Income Statement:	Units:	Projected - Combined Period: FY16	FY17	FY18	FY19	FY20
Acquirer - Standalone EPS:	$ / Share		$ 1.99	$ 2.22	$ 2.42	$ 2.62
Earnings Per Share (EPS):	$ / Share		**$ 1.97**	**$ 2.21**	**$ 2.41**	**$ 2.62**
Accretion / (Dilution) - $:	$ / Share		$ (0.02)	$ (0.01)	$ (0.01)	$ 0.00
Accretion / (Dilution) - %:	%		(0.8%)	(0.6%)	(0.3%)	0.1%
Pro-Forma Earnings Per Share (EPS):	$ / Share		**$ 2.00**	**$ 2.24**	**$ 2.44**	**$ 2.65**
Pro-Forma Accretion / (Dilution) - $:	$ / Share		$ 0.01	$ 0.02	$ 0.02	$ 0.03
Pro-Forma Accretion / (Dilution) - %:	%		0.7%	0.8%	0.9%	1.2%

Real-Life Usage

- **Real Life:** A banker could go to Starbucks and say, "On a Pro-Forma basis, this deal to acquire Krispy Kreme would be accretive!"

- "Therefore, the Board and your shareholders would be more likely to approve, and the deal would be easier to justify in the press."

- **BUT:** Would anyone take this argument seriously?

- **AND:** Should you even *use* "Pro-Forma" metrics in M&A analysis?

- We'll present **the arguments** on both sides, and then give our opinion on this issue…

Arguments **FOR** Pro-Forma Metrics

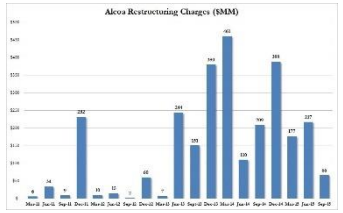
- **Argument #1:** Pro-Forma metrics give a clearer picture of ongoing business performance since they remove one-time expenses

- **Argument #2:** Pro-Forma metrics better represent a company's future earnings potential, which investors use to evaluate it

- **Argument #3:** Items like the Amortization of Intangibles in M&A deals are not "real" expenses because they're non-cash and shouldn't reduce a company's earnings like Interest Expense does

Arguments **AGAINST** Pro-Forma Metrics

- **Argument #1:** Companies abuse these metrics and label many recurring items, like Restructuring, “non-recurring” (See: Alcoa)



- **Argument #2:** There’s little-to-no consistency in the calculations; companies remove wildly different items, so you can’t even use Pro-Forma metrics to compare firms

- **Argument #3:** Some M&A-related items may be non-cash, but they still reflect <u>the cost</u> of doing a deal – and that acquired company will become a part of the core business in the future!

The Bottom Line: Our Views

- **SHORT ANSWER:** We are skeptical of these “Pro-Forma” metrics

- **Point #1:** Yes, you can calculate them if you want, but **always** include the GAAP or IFRS-compliant metrics as well

- **Point #2:** You shouldn’t base a deal or investment recommendation entirely on these metrics, but they can be part of your argument

- **Point #3:** Always *explain* or footnote what you’re doing so that other people understand which expenses have been removed