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US Q3 earnings continue to surpass expectations

But those figures may hide underlying problems: analyst

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EARNINGS continue to come in largely above expectations in the all-important third quarter profit-reporting season, helping US stocks to what has so far been another strong month of advances. But investors need to be particularly wary of these earnings numbers, some analysts are warning.

'With a stock market that is in its seventh straight month of gains and appears vulnerable to a correction after all the major indices have climbed almost 60 per cent or better since the March lows, investors need to take a careful look at what companies are telling them about the health of their operations and their sector in their quarterly reports,' said Jeff Middleswart, research director at Behind the Numbers, a firm that does earnings analyses for Wall Street and institutional clients.

The quality of earnings numbers and what those numbers indicate about the future go far beyond the few featured figures, such as year-over-year earnings per share, revenue and sales, that typically get the lion's share of attention - and have helped stocks rally over the past two weeks as Q3 announcements poured in.

'You have to be careful not to allow yourself to be dazzled by the most obvious numbers because sometimes they mask fundamental problems,' Mr Middleswart said.

Indeed, on Wednesday the US market flipped from what appeared to be a trading session of solid gains to a worrying loss when a brokerage firm analyst downgraded Wells Fargo following its Q3 profit report, despite the fourth-largest US bank by assets turning in a bottom line that walloped analysts' estimates by almost two to one.

Dick Bove, a banking analyst at Rochdale Securities, downgraded Wells Fargo from 'buy' to 'hold' after the bank posted Q3 net income of US$3.24 billion or 56 US cents a share. Consensus analyst estimates were for earnings of 37 US cents a share and revenue of US$21.63 billion.

Noting that much of the bank's profit came from hedges on its mortgage servicing portfolio, and that loan losses were continuing to mount, Mr Bove categorised its earnings as 'pretty poor'.

Wells Fargo slumped 5.1 per cent on the day, and investors sent the major indexes tumbling too. The Dow Jones Industrial Average dropped 92 points, losing its grip on 10,000 as it closed at 9,949.36. The S&P 500 fell 10 points and the Nasdaq Composite lost 13 points.

Stocks appeared to be recovering early yesterday as the Dow climbed 25 points in the first minutes of trading on the New York Stock Exchange. By 10am, the blue -chip index was hovering just above even.

But as corporate profits will be a key factor in trading for another two weeks, Mr Middleswart said more sell-offs could be in the offing for some major companies whose earnings numbers may look good at first glance.

'A lot of companies play a game with their earnings reports, doing everything from making apples-to-oranges comparisons to hiding bad numbers within good ones, but if you know how to look and where, you can tell what they're doing,' he said.

One popular technique that companies have been employing for the past several quarters, he said, is slashing their working capital reserves and marketing budgets to 'untold lows' to achieve big cost-cutting results.

'Cost-cutting has been the main reason so many companies were able to 'surprise' Wall Street with their earnings in the past couple of quarters, but some of these manoeuvrings are going to come back to hurt them as the economy enters its recovery mode,' Mr Middleswart said.

Major culprits include Colgate, Kraft, Office Depot, Avery and Dennison, he said.

'When they have to re-stock their shelves, hire back workers, re-start advertising and marketing campaigns, those expenses are going to shoot way, way up, in some cases more than quadrupling. They might get one or two quarters of good profits - until the cost numbers catch up.'

Retailers like Starbucks and J Crew have made investors happy in recent quarters by posting improving sales, but they've done so partly by touting growing store sales numbers without accounting for many stores they had closed.

'Taking those closed stores out of the monthly and yearly comparisons makes a huge difference. It's not really growth, but a gimmick,' said Mr Middleswart.

The team at Behind the Numbers also looks out for companies making accounting changes for no particular reason other than that they help their bottom lines.

'Iron Mountain, for instance, moved its capital leases into the operating leases category to get rid of depreciation expenses, then made a big deal about how much its Ebita number that determines earnings per share grew.'

Mr Middleswart advises investors to look for the difference between working capital and cash flow this year versus last year.

'How much cash flow did they pick up from taking working capital out of the numbers? If it's significant, it will show up a couple of quarters down the line,' he said, pointing to jewellery retailer Tiffany and food distributor Sysco Foods as prime examples.