Where Are The Costs Of Acquisitions?: Celestica Leaves Them Out: Unique Accounting Method Conceals Thin Profit Margin

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Celestica Inc.'s business rests primarily on buying its rivals and consolidating its industry. But you'd never know it from looking at its quarterly earnings reports.

Like dozens of others in high-technology fields, Celestica's unique accounting methods to calculate "adjusted net earnings" aren't recognized by Generally Accepted Accounting Principles. What's more, Celestica's calculations of ever-growing profits ignore the large costs arising from the string of acquisitions, which are central to its growth strategy.

Digging beneath the surface of Celestica's numbers exposes a company whose profits have always teetered on razor thin margins, even when business was surging. Last year's sharp slowdown in the telecom business pushed them off the razor's edge and into the red -- a fact that Celestica's management would prefer you look past. You do so at your own risk, analysts say.

"Celestica is in the acquisition business," said **Anthony Scilipoti**, vice president of **Veritas Investment Research** in Toronto. "To exclude certain acquisition costs and then claim overall profit is incongruous with the company's business model."

In fact, Celestica's earnings contortions are not uncommon in its industry, **Mr**. **Scilipoti** said. Each of the company's main competitors are following broadly similar strategies for growth, and each have found ways to minimize the impact of acquisitions on their bottom-line.

Every day Celestica manufactures thousands of pieces of electronic equipment for other companies to sell. Nortel Networks Corp., for example, contracts Celestica to assemble telecommunications gear for sale to huge telecom carriers such as AT&T Corp.

The company's plan is to acquire low-margin assembly operations from companies such as Nortel and Lucent Technologies Inc., securing long-term sales contracts in the process. By consolidating operations and making the businesses more efficient, Celestica aims to improve profit margins.

The firm's "adjusted net earnings" accounting seems to provide ample evidence that management is doing just that. But applying Generally Accepted Accounting Principles wipes out much of the company's progress. Taking into account the large incremental costs arising from its string of acquisitions, it appears Celestica has made little progress toward its central goal of improving profit margins.

Celestica's supporters often refer to the company as a "growth machine," pointing particularly to remarkable improvement in the company's revenue since 1998. In four years, annual sales have risen from $3.24-billion to $5.3-billion, then to $9.75-billion and to last year's record $10-billion. Its "adjusted net earnings" have fared even better, rising from $45.3-million in 1998 to $321-million last year.

But using GAAP-approved accounting methods shows Celestica actually posted a net loss of $40-million last year, after posting a $206.7-million profit in 2000, and net income of $68.4-million in 1999.

Why the great disparity? Because Celestica's "adjusted" calculations exclude the amortization of intangible assets, such as goodwill, incurred in its series of recent acquisitions. It also ignores all costs that arise from integrating purchased businesses. Those costs rose 42% to hit a record high of $22.8- million last year, as revenue stagnated.

All charges the firm considers unusual, such as restructuring and severance costs from laying off excess staff, and the writedown of bad investments and depreciating inventory, are also ignored. Those amounted to $273-million last year.

Given the size and recurring nature of many such acquisition costs, many have questioned the usefulness of adjusted figures in the electronics manufacturing services industry. The firm says in its earnings statements that "as a result of the significant number of acquisitions made by Celestica over the past four years, management... uses adjusted net earnings as a measure of operating performance on an enterprise-wide basis."

But the footnotes of its financial statements seem to totally undermine the very "adjusted" figure emphasized in management's comments. "Adjusted net earnings is not a measure of performance under [Generally Accepted Accounting Principles]," the company writes. "Adjusted net earnings should not be considered in isolation or as a substitute for net earnings prepared in accordance with GAAP, or as a measure of operating performance or profitability."

It's the adjusted figure that analysts usually cite as the prime indicator of Celestica's performance, yet the firm feels compelled to warn shareholders against viewing it as a measure of operating performance.

A spokeswoman for Celestica said no one was available to comment on the issue.

Critics of GAAP say the old accounting methods are out of step with a new economy in which companies frequently make cashless takeovers using stock as currency. They say GAAP gives too much weight to non-cash items, which can unfairly depress earnings following acquisitions to build business.

It's highly debatable whether the limitations of GAAP apply to Celestica, considering that most of its acquisitions in recent years have been made using cash. But even if one gives it the benefit of the doubt and accepts that amortization of acquired intangible assets is a legitimate exclusion from cash earnings, the same can't be said for acquisition-related integration costs, says Robert Reid, an analyst and head of Independent Equity Research.

Celestica has made 18 acquisitions in the past four and a half years. Between 1998 and 1999, 39.8% of Celestica's revenue growth came directly from acquisitions. Between 1999 and 2000, its reliance on acquisition-driven growth increased slightly, to 40.8%. Last year, sales growth virtually ground to a halt, despite closing six acquisitions worth more than $2-billion.

The costs of integrating these businesses are paid in cash, and have been a part of Celestica's business every year since the company went public. "These integration costs are not really one-time unusual items," he said. "They are going to continue to be there for several years as long as you continue to grow this business through acquisitions. You can't simply look at the pro-forma numbers and consider it the entire picture."

Adding integration-related costs back into Celestica's adjusted bottom line erodes the reported profit from $91.9-million to $37.2-million in 1998.

Last year, including integration costs and charges related to severance and the termination of leases on closed factories cut Celestica's reported profit by more than half, to $159.6-million.

Many investors might consider it irrelevant to quibble over the accounting treatment of $22.8-million in integration costs for a company that had about $10-billion in revenue last year. But when considered in the context of Celestica's minuscule profit margins, the impact is much greater.

A closer look at the cash costs in Celestica's operations and acquisitions shows that the company's claims of improving profitability have long been exaggerated. Of even greater concern for investors is the fact that the company's tiny margin improvements took a tumble in 2001, as Celestica was forced to close plants and lay off staff to cope with its flagging business.

Profit margins are a contentious issue among Celestica shareholders and analysts. Skeptics have long complained that the firm's gross profit margins are far too narrow to ensure consistent, long-term profitability and stability in the stock.

The gross margin includes only revenue minus cost of sales, or the direct cost of parts used in the product. It does not include any of Celestica's selling, general or administrative costs, not to mention larger corporate expenses such as integration. That gross margin has hovered for four years near 7%.

The firm's supporters maintain that its "adjusted net" margin is a more significant measure of its progress. That number improved from 1.4% in 1998 to 2.3% in 2000 and 3.1% last year. But the problems of the "adjusted net" margins are the same as those of Celestica's idiosyncratic accounting: They ignore the real costs of integrating acquired businesses and restructuring when the operations run aground.

Adding back those costs shows that Celestica's margins in 1999 were 2.1%. The following year they improved slightly to 2.9%. And with last year's extensive restructuring operations, which saw about 12,000 workers laid off and several facilities shuttered, those margins took a jolting step backward, to just 1.6%.

Again, shareholders wouldn't know this unless they calculated the costs themselves using various pieces of information in the company's income statement and footnotes, because the firm only discloses gross and adjusted margins.

So why do Celestica's shares continue to trade at a high price-to-earnings multiple when compared with the broad TSE 300 and its main competitors in the industry? Solectron Corp., for example, trades at about 18 times its 2001 earnings, while Sanmina Corp. is valued near 25 times trailing earnings. Celestica trades closer to 28 times last year's earnings. Analysts say its premium comes from its relatively healthy balance sheet and the fact it has consistently met forecasts.

The trouble is that those forecasts are based upon accounting that critics say significantly overstates the firm's profitability, quarter after quarter. In a report to clients last year, **Mr**. **Scilipoti** advised clients that the electronic manufacturing industry's "adjusted net income" figures are fundamentally flawed.

He warns that with most stock analysts still focusing on adjusted earnings, stock valuations have remained dangerously high.

"We can see minimal justification for analysts to adopt 'adjusted net earnings' as an evaluation tool for Celestica," **Mr**. **Scilipoti** said. "Other than the need to justify stratospheric price-to-earnings multiples."

DIFFERENT LINES TELL DIFFERENT STORIES:

Celestica's Margins

	1998	1999	2000	2001
Gross margin	7.1%	7.2	7.1	7.1
Adjusted net margin *	1.4%	2.3	3.1	3.2
Net margin **	1.1%	2.1	2.9	1.6

** Celestica's adjusted net margin, excluding acquisition-related costs and other charges.*
*** Includes the effect of restructuring charges, integration costs at acquired businesses and, in 2001, costs to terminate leases*
andclose facilities.