# Accounting Alert

VERITAS INVESTMENT RESEARCH

| Company | Ticker | Rating | Intrinsic Value | Current Price |
|---|---|---|---|---|
| Brookfield Business Partners L.P. | BBU | Buy | | NYSE: $25.14 USD |

# Accounting Alert: Hidden Costs

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Based on improved disclosure in the recently filed 2021 annual report, we have realized that BBU has been excluding a much higher amount of restructuring, severance, transaction, and other business losses/provisions from reported FFO than we previously thought. Over the past three years, excluded costs averaged $160 million per year or 14% of the reported FFO.

Although the company excludes these costs as non-recurring and considers them not reflective of normal operations, we beg to differ. These expenses have recurred in each of the past five years and are an essential part of the private equity business model, particularly given that BBU's FFO includes realized gains on capital recycling activities.

We also note that BBU's quarterly disclosures in supplemental and financial statement filings do not separately quantify the impact of the excluded costs. Therefore, it is near impossible to make the necessary adjustments to the reported quarterly results on a timely basis. Instead, investors must wait until the company releases annual filings, which most recently occurred nearly 2.5 months after the company reported its Q4-F21 results. A timelier disclosure and quantification of these charges would increase transparency.

We reduce our intrinsic value estimate to $36.00/share from $38.00/share to account for incremental future restructuring and transaction costs above our prior assumption. We continue to see a solid risk-reward tradeoff for the business and maintain our BUY recommendation on the overall strength of the existing and recently acquired businesses, FCF accretion from recent acquisitions and potential asset sales, which could re-rate valuation higher.

## Other Expense Matters

As we explained in our initiating coverage report (**Method to the Madon(ess)**), BBU regularly excludes substantial portion of "other income/expenses" from the reported FFO. Although BBU's filings included some limited qualitative descriptions, quantitative disclosure was unavailable beyond generic commentary lumping multiple income and cost accounts together.

Based on the little available disclosure and our past discussions with management, we understood that most of these amounts were driven by unrealized gains/losses on derivatives and public securities, which incidentally obscured the impact of various cash-based expenses on the reported FFO. The net expense included transaction, severance, restructuring and other similar costs.

The company excluded these costs claiming these are: *"not normal, recurring income or expenses necessary for business operations"*. We beg to differ, as these costs have recurred in each of the past five years and are an essential part of BBU's business model of continuous capital recycling: buying companies, making operational improvements, and reselling at higher prices down the road.

Further, BBU's FFO and our valuation model includes realized disposition gains. Therefore, in our opinion, an exclusion of transaction/ restructuring and other costs necessary to acquire, improve and operate the acquired businesses overstates economic value creation.

Based on the available disclosure, we estimated that the relevant costs ranged between $18-$50 million in 2017-2020 and reduced Veritas adjusted FFO accordingly. However, due to improved disclosure provided in BBU's 2021 annual report, we realize that actual operating costs excluded by BBU were much higher compared to our estimates.

Notwithstanding increased transparency, we note that BBU's quarterly disclosures in supplemental and subsequent financial statement filings do not separately quantify the impact of the excluded restructuring, severance, transaction, and other relevant costs. Therefore, it is near impossible to make the necessary adjustments to the reported quarterly results on a timely basis. Instead, investors must wait until the company releases annual filings, which most recently occurred nearly 2.5 months after the company reported its Q4-F21 results.

We reproduce the nature and BBU's proportionate amounts of the excluded expenses and the offset from unrealized revaluation gains below:

- **2021:** $52 million of business separation expenses, stand-up costs and restructuring charges, $24 million of transaction costs and $31 million of other (unspecified) expenses. These were netted against $79 million of net unrealized revaluation gains.
- **2020:** $134 million of provisions for potential productivity impacts and damages related to business interruption and work stoppages, $67 million of product line exits, contract write-offs and production relocation costs, $60 million of business separation expenses, stand-up costs and restructuring charges, $30 million of transaction costs, and $6 million of other expenses. These were netted against $168 million of unrealized net revaluation gains.
- **2019:** $69 million of restructuring charges, $48 million of transaction costs and $32 million of other (unspecified) expenses.

Unfortunately, we do not have granular disclosure for other years but we know that BBU incurred similar costs in 2017-2018.

Based on the improved disclosure, Figure 1 quantifies the impact of the excluded costs on the reported FFO (we ignore unrealized gains as BBU's FFO includes gains once they are realized):



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Figure 1

***The Impact of Excluded Costs on Reported FFO***

Amounts in millions of US dollars

| | 2021 | 2020 | 2019 | Total |
|---|---|---|---|---|
| FFO - reported | 1,573 | 870 | 1,102 | 3,545 |
| Less other costs, net of tax (restructuring, transaction, severance, COVID-related) | (92) | (255) | (132) | (479)* |
| Veritas-adjusted FFO | 1,481 | 615 | 970 | 3,066 |
| Impact on FFO | **6%** | **42%** | **14%** | **16%** |

**The total amount averages to $160M/yr and accounts for 14% of total reported FFO.*

*Source: Company reports and Veritas.*

Although the amount of these charges will vary year over year, in our valuation we assume these costs will amount to 6% of FFO. Therefore, we reduce our intrinsic value estimate to $36/share from $38/share to account for incremental future restructuring and transaction costs above our prior assumption of $40-$50 million/year.

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*Our analysts rate stocks based on their view of how the stock will perform over the next 12 months relative to their sector of coverage.*

| Recommendation | Description |
|---|---|
| **Buy** | Expected to generate a meaningful positive return or outperform analyst's sector coverage over the next 12 months |
| **Reduce** | Expected to underperform analyst's sector coverage over the next 12 months |
| **Sell** | Expected to generate a meaningful negative return over the next 12 months |

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