June 22, 2018

BIA Peers Behind the Stage Curtain of GE's "Success Theater"

Introduction

General Electric, a founding member of the Dow Jones Industrial Average, will be dropped from the Dow after over a century, marking a symbolic low point for the conglomerate that was once a pillar of the American economy. In February, *The Wall Street Journal* published an extensive chronicle of GE's precipitous decline over the past few years. The article attributes investors' unawareness of GE's woes in part to former CEO Jeffrey Immelt's "success theater," which cherry-picked positive information and suppressed bad news, both within the Company's management and to the public. The *Journal* article recounts an example during a May 2017 presentation at the Electrical Products Group Conference in which Mr. Immelt declared that "this is a strong, very strong company" and defended his 2018 profit goal even though it had been "long abandoned" by Wall Street.

At BIA, we apply our proprietary Tactical Behavioral Assessment® (TBA™) methodology to analyze management teams' statements and provide insight into the completeness, transparency and confidence surrounding all types of business issues. If investors at that May meeting had seen BIA's behavioral analysis of the event, they would have had a high degree of conviction that even Mr. Immelt himself was not actually confident in the positive outlook he espoused. In fact, BIA's analysis has uncovered hidden insights about the challenges facing GE's performance throughout the Company's recent skid. In this edition of *Between the Lines*, we trace BIA's behavioral analysis of GE, showing how our unique methodology allowed us to detect management's deception and develop a clearer picture of the Company's true condition for our clients.

Note: hyperlinks take you to relevant news reporting on GE throughout this period.

Act I: GE's Phantom Targets

During that May 2017 presentation, Mr. Immelt assured investors of GE's strength and reaffirmed their expectation to hit their $12 to $14 billion target for industrial cash flow for 2017. However, Mr. Immelt displayed significant behaviors throughout the call when discussing this issue. For example, Mr. Immelt qualified in his opening remarks that the $12 billion to $14 billion target was "kind of" the way they thought about cash, which indicated that he was not being fully transparent about their cash flow targets. He also repeatedly failed to answer when asked about the impact of Alstom's issues on cash flow, cash generation in the power business, and their ability to alleviate pressure on cash from LTSAs. *These behaviors led BIA to conclude that management was withholding unfavorable information about their near-term cash flow outlook and had less confidence in hitting their $12 billion to $14 billion target than they portrayed.*

In addition, BIA observed significant behaviors around management's 2018 EPS outlook during that same call. When asked if they still anticipated hitting the $2 EPS target in 2018, Mr. Immelt failed to directly confirm this. Instead, he qualified that it would be "in the range," which, in lieu of more specific numbers, indicated that he lacked confidence in their ability to hit the $2 target. Mr. Immelt tried to assure investors that it was still possible by saying that "if we wanted to take it off the page, we would have taken it off the page." However, this statement also revealed that they had likely considered taking the $2 target "off the page." In addition, he tried to divert focus away from the EPS target and focus investors on other aspects of the business by stating that "I want to get back to 3% to 5% organic growth, 100 basis points plus of margin enhancement, good free cash flow conversion." *Ultimately, these behaviors led us to conclude that management did not expect to hit the $2 EPS target in 2018*.

On June 12, 2017, Jeffrey Immelt announced that he would be retiring, paving the way for John Flannery to begin as CEO on August 1. Nevertheless, in the following earnings call, GE continued to affirm these guidance targets to investors. However, they drastically reduced both targets at a November Investor Conference. For industrial cash flow, management lowered guidance from $12 billion to $14 billion to “about $7 billion.” They also nearly halved their EPS target, guiding down to $1.00 to $1.07 for 2018. GE shares fell 8% following this news.

Act II: GE Powering Down

Throughout this period, BIA was also able to gain valuable insight into GE’s struggles within its crucial Power division before many investors understood the full scope of those issues. During their presentation at Power & Renewable Energy Analyst Meeting in March 2017, management noted that “we have said” that they saw the Power Services franchise growing in mid-single digits in 2017 and beyond. Their need to divert back to a previous statement instead of simply saying that they still expected this level of growth suggested that their expectation had changed, and that they no longer had confidence in the mid-single-digit growth outlook for the Services business. In addition, management failed to provide a sufficient amount of detail when asked how they were going to drive second-half improvement in margins for Power Services. *These behaviors indicated that management’s outlook for the Power Services business was weaker than they were portraying to investors.*

Management also displayed significant behaviors when discussing their expectations for AGP growth. They said that "AGPs are actually a relatively small part of the overall upgrade story in Power Services" in an effort to downplay the importance of AGPs for the Services business. Similarly, they commented that "more importantly" they saw "overall" upgrade unit count doubling across the entire power island in an effort to further convince investors that AGP growth was not crucial to their ability to drive growth. Later, management was asked if they thought they would hit a mature penetration rate for AGPs where they get another 5% to 10% of their installed base each year. They tried to give the impression that they would still have significant opportunities with other upgrades, saying that "the 9F is pretty much wide open" and "don't think once you do an upgrade you never do it again." However, in lieu of more detail, qualifying that the 9F is "pretty much" wide open suggested that the opportunity for the 9F was more limited than implied. In addition, management stated that "it's our challenge to bring technology to when that upgrade happens to have it be an economic good trade-off," which, taken literally, signaled that it is a "challenge" for them to continue to develop attractive upgrades. Ultimately, they did not actually answer whether they thought they could get to a point where they get penetration at an additional 5% to 10% of their installed base every year, suggesting *they did not have confidence in their ability to do this.*

BIA continued to point out behavioral concern around the power business on the Q2 2017 earnings call in July. GE management said that "the business still thinks" they will do 155 to 165 AGPs in the year. This qualifier was especially notable because management disassociated themselves from the prediction, instead saying the “business” itself was what had the expectation, not them. This suggested that management was not as confident that they would reach the level of 155 AGPs as they wanted investors to believe. Management also said that "when [they] get up in November, [they] will share [their] view of where [they] think the Power business is going for 2018." This allowed management to avoid providing the requested information right then, giving them time to craft a message around Power outlook. *Overall, management’s behaviors suggested that their outlook for AGP growth and penetration was less positive than they were willing to acknowledge.*

Altogether, these behaviors suggested that *management’s expectations for the Power business were weaker than they were leading investors to believe*. It only took one more quarter for these concerns to come to fruition. On the Q3 2017 earnings call, GE reported a 51% drop in profit for the Power business and guided for operating profit to decline by 20% in 2017. They also prepared investors for a multi-year period of difficulty, saying that they expected the power business to decline 25% in 2018. In addition, management conceded that they now expected Power Services to be down 20% for 2017, a dramatic reduction from their previous outlook of up mid-single digits. Furthermore, they dropped their guidance for AGP growth significantly, lowering the full-year outlook from 165 to 80-90 AGPs.

Act III: Times, They are a ChanGEin’

The Q3 earnings call in October represented the beginning of the end of GE’s “success theater.” John Flannery exclaimed that it was “clear from our current results that we need to make some major changes with urgency and a depth of purpose.” However, even after GE acknowledged publicly that they would need to make significant changes and recovery would be prolonged, BIA continued to shed light on significant behavioral concerns within GE’s commentary about their turnaround plan.

Prior to that call, BIA had analyzed Flannery’s comments to gain insights into his strategic vision. Just after coming on as CEO, Mr. Flannery stated that he wanted to “repeat the process I used in Healthcare” in order to change the culture at the Company. In an exchange during the GE Healthcare presentation in June, before he succeeded Mr. Immelt as CEO, he notably qualified that "I think" and "I'd say" they were able to rally the organization around that message, which suggested that there was some uncertainty over how effective this was. In addition, Mr. Flannery stated that they made a "fair amount" of personnel changes and mixed up "a lot" of people because they had to "inject some new thinking." In lieu of any specifics about the magnitude of these changes, these comments signaled that *staff turnover was more significant during this period than management lets on*.

Mr. Flannery's behaviors suggested that he had some uncertainty over how effectively he was able to get people to buy into his philosophy at GE Healthcare, and that the "cultural change" implemented in the Healthcare business came more from personnel changes and turnover than from existing personnel buying in to his changes. *This background suggested that as Mr. Flannery began his tenure as CEO and tried to "repeat the process" he undertook at GE Healthcare, he would make aggressive personnel changes in order to better align the overall company with his vision*. Sure enough, shortly after Mr. Flannery became CEO, GE's chief financial officer, head of marketing efforts, and a top international executive each left the Company.

BIA's analysis also helped alert our clients that sweeping changes would not be confined to executive roster changes. During the Q3 call, management tried to imply that the dividend would be maintained, stating that "the dividend is a priority in our capital allocation framework." However, they also used this reasoning to preemptively justify a dividend cut when they said that they would find an "appropriate balance of growth investment and dividend payout," signaling that management was considering a dividend cut. *Then, when explicitly asked how sustainable the current dividend was, they were reluctant to answer the question, suggesting that the current dividend was less sustainable than they wanted to admit*. Only weeks later, GE announced that it would be cutting its dividend by half, driving shares down over 10% over the following two days.

In a CNBC interview the day of GE's Q3 earnings report, Mr. Flannery laughed when asked if GE will announce board changes. This laughing demonstrated a heightened level of anxiety in response to the question. He then failed to answer the question and said that "it's just an ongoing issue," in an effort to excuse his failure to answer. *From these behaviors, BIA concluded that board changes would likely be announced in the near future*. Less than a month later, GE announced that the board of directors would be reduced from 18 to 12.

In that same CNBC interview, Mr. Flannery was asked to explain why GE would remain a conglomerate. He argued in favor of keeping GE together, but went on to caveat, "that said, we have to prove day in, day out that that format is optimal," signaling that he likely found it more challenging to justify the value in keeping the companies together than he wanted to admit. When the interviewer followed up to ask if GE was committed to keeping the companies together, Mr. Flannery failed to answer the question and instead said that he was "committed to improving the operations of the Company" and that he was not "wed" to the current format, indicating that he was not committed to keeping the current structure of the business. Along the same lines, when asked if the $20 billion in asset sales was indicative of a more meaningful structure change within the Company, Mr. Flannery again failed to answer the question. *These behaviors led BIA to conclude in that analysis that GE had more significant plans to restructure the Company than Mr. Flannery wanted to reveal.*

Shortly after the interview, GE announced that it was looking to exit from its railroad business and *The Wall Street Journal* reported that it was exploring options for the GE Transportation Division. On a conference call in January 16, GE went a step further, stating that that they were going to examine the "best structure or structures of our businesses," and they finally announced on May 21 that they made a deal to merge the transportation unit with Wabtec. A *Wall Street Journal* report posited that GE was essentially "considering breaking itself apart" in order to reorient its businesses.

Epilogue

Through the machinations of Jeffrey Immelt's Success Theater, GE was able to effectively disguise the substantial problems its businesses faced for years. However, by applying our Tactical Behavioral Assessment® (TBA™) methodology, BIA was able to identify many of these problems long before they were publicly acknowledged. We also provided our clients with valuable insights about how the 125-year-old business would transform itself as it started down the road to recovery. Mr. Immelt and GE management put on a convincing performance in the Success Theater, but BIA saw what was happening backstage.

BIA Coverage of General Electric October 2014 through January 2018

BIA Report Title	BIA Takeaways
"Healthcare is on Life Support" Q3 2014 Earnings Call Oct. 17, 2014	• Healthcare will continue to struggle in the near term. • H Turbine orders are seeing more of an impact from re-permitting than admitted.
"GE LEAPs and Flies Away from Supply Chain Questions" Investor Conference Feb. 8, 2017	• The problems in the LEAP supply chain are more significant than management wants to disclose to investors. • Management lacks confidence in their ability to hit their target for full year LEAP shipments in 2017. • The LEAP OE shipments will not break even on a unit cost basis at any point in the near-to-medium term. • The sales headwind from rate reductions on the 777, 747, and A380 will be more substantial than management portrays.
"Power Outages Looming in the Power Service Outlook" Investor Conference Mar. 8, 2017	• The outlook for the Power Services business is not as positive as management portrays. • Management expects AGP growth and penetration to be weaker going forward that they are willing to acknowledge.
"Cash Flow and Earnings Dimmer Than Portrayed" Investor Conference May 24, 2017	• Management does not expect to hit the $2 EPS target in 2018. • Management is withholding unfavorable information about their near-term cash flow outlook and likely has less confidence in hitting their $12 billion to $14 billion target than they portray. • The equipment margin will be weaker in the near term than management wants to acknowledge. • GE Digital will not be a meaningful external contributor in the foreseeable future, and management lacks confidence that it will even benefit GE internally to the extent they imply.
"U.S. Imaging Market Share Could Use a Checkup" Investor Conference June 1, 2017	• Mr. Flannery expects 2017 Healthcare performance to be weaker relative to 2016 than he implies, with pricing pressure a particular challenge. • The market share position of the imaging business in the U.S. is not as strong as management wants investors to believe.
"Power and Cash Flow Outlook Flickering" Q2 2017 Earnings Call July 21, 2017	• Cash Flow will likely not improve in 2018 to the extent that management wants investors to believe. • Management is less confident in the prospects for the Power business through 2018 than they want to acknowledge.
"Divest to Impress" CNBC Interview Oct. 20, 2017	• GE has more significant plans to restructure the Company than Mr. Flannery wants to reveal. • Board changes are likely to be announced in the near future.
"We Bring Good Things to Life... Except a Generous Dividend" Q3 2017 Earnings Call Oct. 20, 2017	• Management has plans to cut their dividend. • The Power business will likely weigh more on CFOA improvement in 2018 than management wants to admit. • GE Capital is having more difficulty paying back the receivable than management wants to reveal.
"GE Divestitures Will Drain Earnings Power" Special Call Nov. 13, 2017	• The asset exits will have a more significant negative impact on GE's free cash flow growth and earnings power than they are willing to admit. • Management's expectations for the net restructuring benefit in 2018 are less positive than they portray. • Management is having more difficulty figuring out how to restructure Alstom than they want to admit. • There is likely to be a greater level of contention among the reorganized Board than management lets on.
"GE Turning Out the Lights on 2018 Outlook" Q4 2017 Earnings Call Jan. 24, 2018	• Management is less confident than they portray in their ability to get within the $1 to $1.07 EPS range in 2018. • Industrial segment operating profit growth in 2018 is going to be lower than management wants to reveal. • Management is not confident in their ability to deliver on their 2018 free cash flow target. • Management is more concerned than they want to admit about the implications of the SEC investigation into contract assets.

About this Report:

This report represents the application of BIA's Tactical Behavior Assessment® methodology and reflects BIA's assessment of the completeness and responsiveness of statements made during earnings conference calls, television interviews and other presentations. In each case, our assessment represents the opinion of BIA applying the Tactical Behavior Assessment® methodology and does not purport to indicate that any individual is in any specific instance being truthful or deceptive. BIA does not make stock recommendations. Under no circumstances is BIA's analysis intended to be a recommendation to buy or sell the securities of the company which is the subject of this report.

About BIA:

Business Intelligence Advisors (BIA) is the leading Intelligence Solutions research and advisory firm. Founded in 2001 on the principle that Intelligence techniques originally developed for the national intelligence community could be powerfully applied to the private sector, BIA has developed a ground-breaking suite of service offerings to provide clients with an edge in collecting and evaluating information critical to their success – whether that means making a more informed investment decision, identifying hidden risks, or enhancing due diligence efforts. BIA's services, which include proprietary Behavioral Intelligence Research, Expert Advisory, Investment Intelligence, and Learning & Development Solutions, are delivered by a team of in-house experts from the national intelligence and finance fields.

www.biadvisors.com