BEHIND THE NUMBERS
Quality of Earnings Analysis

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Agilent Technologies, Inc. (A)
Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of A with a 5+ (Strong) rating.

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

Agilent reported adjusted EPS of $1.06 in the 1/21 quarter which was 16 cps ahead of the consensus estimate. We saw no significant unusual benefits to the quarter and consider it a relatively high-quality beat.

While we do not like the typical adding back of intangibles amortization to non-GAAP results, A does not fit the typical serial acquirer mold which reduces our level of concern. Otherwise, we consider the company's accounting to be fairly straightforward and high quality.

What is weak?

- A has made acquisitions in the past although we would not label it as a serial acquirer based on the activity of the last few years. The last major deal was the $1.17 billion acquisition of BioTek in which roughly half the purchase price was assigned to goodwill (not amortized) and half to intangible assets. The company adds back amortization of acquired intangibles to its non-GAAP earnings which amounted to about 15% of trailing 12-month adjusted income before taxes. Amortizing its goodwill balance over 40 years

would reduce profits by another 7%. These amounts are not as large as some companies we follow but are still materially overstating non-GAAP results, in our opinion.

- The non-GAAP tax rate fell to 14.75% from 15.5% last year. This added a little over a penny to EPS growth in the 1/21 quarter. The company is forecasting a 14.75% effective rate for FY 2022 so the boost to EPS growth from a lower rate should fade after the next couple of quarters.

What is strong?

- A's revenue recognition policies are very straightforward. Its equipment, consumables, and even most of its software licenses transfer to the customer at the point of transfer of control to the client. Service and extended warranties are billed upfront and recognized over the contract term on a straight-line basis. This results in a relatively low deferred revenue balance and little subjectivity in the pace of recognizing revenue. Deferred revenue days run about 25 days of sales and have tracked fairly consistently.

- The company has determined that certain sales incentives meet the requirements to be capitalized under ASC 606. However, it does not disclose these amounts, saying that the change in total capitalized costs are immaterial to results.

- A positive mark for the company's acquisition accounting is the lack of any meaningful write-offs of intangible assets in the last few years. There have been no goodwill impairments in the last three years, only $21 million in impairments of purchased intangibles, and a $90 million write-down of in-process R&D associated with the shutdown of its sequencer development program.

- The typical valuation of uncertain tax positions was the only item cited as a critical audit matter by the company's auditor which is a testament to the simplicity of A's accounting.

What to watch

- As noted above, A has made multiple acquisitions in the past. However, we would not label the company as a serial acquirer as it has not made a large deal since 2019 and its net debt level typically runs below 1x EBITDA. However, management indicated on the conference call that it is looking to increase its M&A activity. We will be watching for any change in direction and could reassess our rating if reckless acquisitions become a habit.

- A reports an “other income (expense)” line on the income statement below the operating income line. This amount typically includes items such as loss on debt extinguishment and derivative costs and gains This amount can fluctuate materially and it should be reviewed quarterly for any unusual movement that is not adjusted out of non-GAAP results. In the case of the most recent quarter, other income fell to $3 million from $21 million last year. However, the major drivers including a $5 million loss on early extinguishment of debt in the 1/21 period and a $16 million gain from the change in the value of equity investments in the 1/20 period were adjusted out of non-GAAP results.

- The company maintains a warranty reserve which we will monitor quarterly. However, the reserve and associated provision expense has tracked relatively in line with revenue with fluctuations not meaningfully impacting earnings in the last several quarters.

- We note that the company’s “other current asset” account jumped in the 1/21 quarter to 18.5 days of sales after tracking consistently in the 13 to 15-day range for the last several quarters. We are uncertain of the increase but do observe that the company’s capitalized costs to obtain contracts are included in that account. As we noted above, the company does not disclose detail on those capitalized costs as it deems them immaterial. At this point, we are not overly concerned but will monitor for a sustained increase in the other current asset account which could indicate the delayed recognition of expenses.

- A reports regular charges on its cash flow statement for charges for excess and obsolete inventory. These amounts have remained fairly stable, falling between $4-$10 million per quarter over the last two years. The company also reported sales of previously written down inventory in the costs and expenses discussion of its 10-K. These amounts have also remained consistent over the last three years ranging from $6-$8 million annually. These trends should be monitored for signs of any unusual boost to profitability from selling inventory with an artificially low cost basis.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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