BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Air Products and Chemicals, Inc. (APD) Earnings Quality Update 12/20 Qtr.

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

We maintain our earnings quality rating of 4- (Acceptable)

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

Summary

APD reported EPS from continuing operations of $2.12 in the 12/20 quarter which was 8 cps short of consensus estimates. Management noted on the call that the quarter contained 10-15 cps in incremental COVID-related expenses along with higher maintenance expenses timed around unscheduled plant downtime. To its credit, the company also continues to invest in R&D and business development during the pandemic.

However, investor concern seemed to be mostly focused on the lack of visibility into the reopening of the Lu'An facility. APD participates in a non-consolidated JV with Lu'An to operate a clean energy facility on Lu'An's site in China. The company reached an agreement to reduce its fee received from the JV during the duration of the shutdown in return for extending the contract term. Management indicated that the extension improves the company's total return on the project and it expects the plant to be back online in 2021. Nevertheless, the lower revenue hit the quarter and management has not released much in the way of clarification as to the reason for the shutdown or the exact time frame on reopening. This was a focus of conversation in the Q&A on the conference call with some analysts seemingly concerned that the Lu'An

interruption could be heralding problems with other JV projects in China. While this seems like an overreaction to us, this could be an overhang on the stock for a while.

Overall, we continue to view APD’s earnings to be of solid quality. However, we will refrain from raising our rating at this time due to non-operational benefits to the most recent quarter below without which the earning miss would have been worse.

What is strong?

- As noted above, despite APD’s complex business model which regularly involves huge capital investments to build and operate facilities on customers’ sites under long-term contracts, the company makes relatively few non-GAAP adjustments to earnings.

- We also applaud the company’s regular itemized presentation in its Management’s Discussion and Analysis sections of its SEC filings showing the sources of EPS growth in each period which makes it easy for investors to see when items such as lower tax rates are boosting growth.

What is weak?

- Other income jumped by $10.2 million or 4 cps due to the settlement of a supply contract which was an unexpected benefit to EPS in the period.

- The effective tax rate fell to 19.3% from 19.8% which added about 1 cps to EPS. The company continues to anticipate a full fiscal year 2021 tax rate of 20-21%, so this benefit was not likely accounted for in analysts’ models.

- Pension cost swung from an expense of $400,000 to a $9.5 million income due to lower interest cost and lower amortization of actuarial loss resulting in a 3.5 cps boost to EPS growth. Most of this impact is seen in “other non-operating income.”

- Lower share-based compensation expenses added about 1.5 cps to EPS in the quarter.

- Equity affiliate income rose by 4 cps in the quarter driven by 19% growth in profits from investments in affiliates accounted for under the equity method. Equity income is always a material amount, regularly accounting for approximately 10% of total company pretax profits. In the 12/20 quarter, the company attributed the increase to growth in affiliates in India, Italy, Mexico, and Saudi Arabia. While this is the appropriate way to account for

equity joint ventures in which the company has less than 50% ownership, the lack of visibility into the results makes the growth lower quality.

What to watch

- We note that capitalized contract fulfillment costs have been rising faster than the associated equipment revenues. This would ordinarily be a concern if revenue under the contracts was recognized upfront or ratably. However, equipment revenue is mostly recognized as costs are incurred, and the increase in capitalized costs appears to correspond to a buildup in deferral in the recognition of revenue associated with the projects.

Supporting Detail

Jump in Contract Fulfillment Costs

Approximately 4-6% of company revenue is generated by the sale of cryogenic and gas processing equipment to customers. There is considerable installation time and cost involved with these equipment contracts. The company capitalizes certain costs to fulfill these contracts as described in the 10-K:

> *"Contract fulfillment costs primarily include deferred costs related to sale of equipment projects that cannot be inventoried and for which we expect to recognize revenue upon transfer of control at project completion or costs related to fulfilling a specific anticipated contract."*

Note that these costs are separate from contract acquisition costs such as commissions which the company indicates are not material.

The following table shows the calculation of contracts fulfillment days of sales based on the company's sales of equipment reported in its revenue breakouts:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Sale of Equipment	$161.7	$189.0	$133.7	$133.1
Contract Fulfillment Costs	$140.9	$109.9	$100.7	$84.8
Contract Fulfillment Costs Days of Sales	80.2	53.5	68.5	58.0

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Sale of Equipment	$127.0	$124.6	$94.7	$76.2
Contract Fulfillment Costs	$86.1	$64.5	$66.4	$65.9
Contract Fulfillment Costs Days of Sales	62.4	47.6	63.8	77.8

A disproportionate increase in capitalized costs relative to the growth in related revenue is always a concern as it could indicate that the company is becoming more aggressive in capitalizing expenses to the benefit of profits. However, we are not especially alarmed by the increase in the days of sales figure as the company's recognition of equipment revenue is tied to incurring expenses. Consider the following discussion from the 9/20 10-K on the recognition of equipment revenue:

> *"Our sale of equipment contracts are generally comprised of a single performance obligation as the individual promised goods or services contained within the contracts are integrated with or dependent upon other goods or services in the contract for a single output to the customer. Revenue from our sale of equipment contracts is generally recognized over time as we have an enforceable right to payment for performance completed to date and our performance under the contract terms does not create an asset with alternative use.* ***We recognize these contracts using a cost incurred input method by which costs incurred to date relative to total estimated costs at completion are used to measure progress toward satisfying performance obligations****."*

Unrecognized revenue remains deferred until costs are incurred. The following table shows deferred revenue for the last eight quarters.

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Total Contract Liabilities (Deferred Revenue)	$492.8	$371.7	$368.9	$335.3

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Total Contract Liabilities (Deferred Revenue)	$338.2	$296.6	$233.9	$244.4

Consider the following description of contract liabilities from the 10-K:

> *"Contract liabilities include advance payments or right to consideration prior to performance under the contract. Contract liabilities are recognized as revenue when or as we perform under the contract. The increase in our contract liabilities – current balance primarily relates to new sale of equipment projects as balances associated with our sale of gas contracts are generally related to fixed charges and are relatively consistent period over period."*

Note that since contract liabilities do contain balances associated with gas contract revenue, we are reluctant to relate them directly to equipment revenue as we did with contract fulfillment costs in the first table. However, the company does indicate the increase in contract liabilities is primarily tied to rising equipment sales. Also, the increase in contract liabilities does correspond to the increase in capitalized fulfillment costs. We are therefore not concerned by the rising capitalized costs as in this case, they appear to be essentially tied to a delay in revenue recognition.

This trend should be monitored going forward for any sudden disconnect between the growth in capitalized fulfillment costs and the growth in deferred revenue.

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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