BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Air Products & Chemicals (APD) EQ Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	NA

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

We initiate coverage of Air Products (APD) with an EQ Rating of 4+ (Acceptable).

As we noted in our original review, APD has undergone a massive reorganization in recent years, resulting in huge asset write-offs, major divestitures, and restructurings. However, this appears to all be behind the company. Going forward, we will be watching to see if the unusual charges are indeed behind APD. Currently, we see no major issues with the quality of the company's reported earnings or cash flows, although we do note below that accounts receivable DSOs did increase by a couple of days in the most recent period. We also note that we would like to see better quarterly disclosure of payables, customer advances and any unearned revenue amounts associated with the company's percentage-of-completion accounting.

Accounts Receivable DSOs Up but Not a Major Concern Yet

Accounts receivables DSOs as of the end of the 6/18 quarter jumped by 2.5 days over the year-ago period.

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Accounts Receivable DSOs	53.4	57.2	54.3	52.1

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Accounts Receivable DSOs	50.9	57.4	55.6	56.8

DSOs are still relatively low and are not overly concerned with the quality of reported revenues in the period. Regardless, this is a point to be monitored in upcoming quarters to verify it is not the start of a trend.

Explanation for Jump in Payables and Accrued Liabilities

We note that accounts payable and accrued liabilities jumped significantly in the quarter.

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
COGS	$1,545	$1,507	$1,572	$1,547
Payables and accrued liabilities	$1,968	$1,552	$1,610	$1,814
Payables and accrued liabilities DSPs	116.2	94.0	93.4	107.0

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
COGS	$1,486	$1,404	$1,317	$1,348
Payables and accrued liabilities	$1,534	$1,491	$1,678	$1,652
Payables and accrued liabilities DSPs	94.2	96.9	116.3	111.9

While we are ordinarily concerned by a rise in payables, trade payables account for only around a third of the total account balance with other items such as customer advances and dividends payable comprising the rest. APD does not disclose the breakdown of the account on a quarterly basis, but here is the disclosure from the FY 2017 10-K:

Trade Creditors	$659.5
Customer Advances	$438.9
Accrued Payroll	$187.1
Pension and Retirement Benefits	$22.6
Dividends Payable	$207.5
Outstanding Payments in Excess of Certain Cash Balances	$4.5
Accrued Interest Expense	$42.2
Derivative Instruments	$95.9
Severance and Other Costs	$41.5
Other	$114.6
	$1,814.3

We were initially puzzled by the fact that the payables and accrued liabilities account skyrocketed in the quarter, yet the company's cash flow statement showed that the account was a drain on cash, citing a decline in customer advances, severance payments and incentive compensation as the culprits. One would expect such a large increase in payables and accrued expenses to be a significant boost to cash flow. However, in connection with the company's Lu'An joint venture which was closed in April, the company recognized a liability for its expected cash payments on a loan made by Lu'An in the payables and accrued liabilities account. This was excluded from the statement of cash flows as it was a non-cash transaction. Therefore, the jump in that account is not a concern. However, we do note that we would like to see the company offer more detailed quarterly disclosure breaking out both trade payables and customer advances.

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 recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem as there is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears
1- "Strong Concerns"	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 score may 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 the next quarter. 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.

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