BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Air Products & Chemicals (APD) EQ Review-6/19 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	4+

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

We are lowering our earnings quality rating on APD to 4- (Acceptable) from 4+ (Acceptable).

APD beat estimates by 4 cps in the 6/19 quarter. However, given the material beneficial swing in other income and the material benefit from lower pension expense, our view of the quality of the earnings beat was diminished.

- On the surface, inventory DSIs jumped by more than 6 days versus a year ago. However, this was influenced by a change to 100% FIFO inventory accounting as well as the modification of a hydrogen supply contract to a tolling arrangement in India under which the company no longer records the cost of goods sold. We are not currently concerned by the inventory level.

- Pension expense fell by 2.6 cps in the quarter largely driven primarily by lower amortization of actuarial loss in the international plans. We view this as a non-operational tailwind that will fade in upcoming quarters.

- Other income experienced a positive 3.2 cps swing primarily due to positive foreign currency impacts. Hedging gains reclassified from AOCI actually declined, indicating to us that these gains were likely related to foreign currency contracts not designated as hedges which the company uses to hedge working capital amounts.

- Adjusted operating margin jumped by 270 bps but we estimate about 80 bps of that was due to the modification of the contract in India to a tolling arrangement which reduced sales but had no impact on profits. The remainder of the increase was due to especially positive pricing.

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 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 EQ Review Rating 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.

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.

Disclosure

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