Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

BEHIND THE NUMBERS

Quality of Earnings Analysis

November 12, 2021

Avery Dennison Corporation (AVY)
Earnings Quality Update- 9/21 Qtr.

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

We are maintaining our earnings quality rating of AVY of 4- (Acceptable).

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

Summary

AVY reported non-GAAP EPS of $2.14 in the 9/21 quarter which was 11 cps ahead of estimates. We did notice several non-operating benefits totaling about 7 cps which should reverse to headwinds in upcoming quarters. Investors should be aware of these headwinds, but given the size of the earnings beat in the quarter, we are not downgrading our earnings quality rating for now.

- Provision for sales returns declined as a percentage of revenue which added 3.7 cps to earnings growth in the period.

- The provision for credit losses was a credit of $2.1 million versus a credit of $0.6 million in the year-ago quarter. The decline as a percentage of revenue added about 1.3 cps to earnings growth in the period. AVY increased its allowance for bad debt during the pandemic. The allowance as a percentage of gross receivables reached a peak of 4.0% in the 6/20 quarter before gradually falling back to 2.5% in the 9/21 period. The pre-pandemic norm was about 2%, so we could see another quarter of benefit from unusually low provision expense. However, in the 3/22 quarter, provision expense should normalize and compare against the credits from the 4/21-9/21 quarters. We don't have a pre-pandemic provision expense figure, but if provision expense returned to 0.5% of sales, it would amount to an approximate 10 cps headwind by itself.

- Lower stock compensation expense added 2 cps.

- AVY disclosed in the 10-Q that it received a negative judgment related to its litigation with ADASA which resulted in an additional $35.8 million in potential. The company did not increase its existing reserve for the additional amount leaving open the possibility of a future charge. The note is below:

  "We are currently party to a litigation in which ADASA Inc. ("Adasa"), an unrelated third party, alleged that certain of our radio-frequency identification ("RFID") products infringed on its patent. ***We recorded a contingent liability related to this matter in the second quarter of 2021 in the amount of $26.6 million based on a jury verdict issued on May 14, 2021. During the third quarter of 2021, the first instance judgment associated with the jury verdict was issued. This resulted in additional potential liability of $35.8 million for, among other things, RFID tags sold prior to March 31, 2021 and a royalty on a higher number of tags.*** *In addition, Adasa was awarded a royalty on in-scope tags sold after March 31, 2021; we have largely completed our migration to alternative encoding methods used in our other RFID tags.* ***We did not increase the contingent liability we recorded for this additional potential liability.*** *With continued evaluation of the matter and our defenses, as well as consultation with our outside counsel, we continue to believe that ADASA's patent is invalid and that, even if valid, we have not infringed it, and that the royalty rate used as the basis for the jury's determination is unreasonable under prevailing industry standards, as well as that any liability related to this matter would be substantially lower than that which is reflected in either the jury verdict or the first instance judgment. On October 22, 2021, we appealed the judgment to the United States Court of Appeals for the Federal Circuit and continue to believe meritorious defenses exist to significantly reduce the liability we currently have recorded.* ***We maintained our current contingent liability of $ 26.6 million for this matter as a reasonable estimate within the range of probable outcomes."***

Lower Provision for Sales Returns Added 3.7 cps

AVY discloses its combined provision for credit losses and sales returns on its cash flow statement. It also discloses the provision for credit losses component in a separate footnote. We take the difference between the two to arrive at an estimate for provision for sales returns which is shown in the table below.

	10/2/2021	7/3/2021	4/03/2021	1/02/2021
Sales	$2,072	$2,102	$2,051	$1,991
Implied Provision for Sales Returns	$10.7	$9.4	$10.8	$13.3
Sales Returns as % of Quarterly Sales	0.52%	0.45%	0.53%	0.67%

	9/26/2020	6/27/2020	3/28/2020
Sales	$1,729	$1,529	$1,723
Implied provision for Sales Returns	$12.2	$7.3	$10.9
Sales Returns as % of Quarterly Sales	0.71%	0.48%	0.63%

We see that despite the YOY increase in revenue, the provision for sales returns fell by 19 bps and declined on an absolute basis as well. We estimate that if the provision for sales return expense had remained constant as a percentage of revenue, it would have taken 3.7 cps off of earnings growth in the quarter.

Larger Credit for Bad Debts Added 1.3 cps

The following table shows AVY's provision (credit) for bad debts as a percentage of revenue:

	10/2/2021	7/3/2021	04/03/2021	01/02/2021
Sales	$2,072	$2,102	$2,051	$1,991
Provision (Credit) for Credit Losses	-$2.1	-$0.8	-$1.9	$0.3
% of Revenue	-0.10%	-0.04%	-0.09%	0.02%

	9/26/2020	06/27/2020	03/28/2020
Sales	$1,729	$1,529	$1,723
Provision (Credit) for Credit Losses	-$0.6	$0.3	$20.3
% of Revenue	-0.03%	0.02%	1.18%

We can see that during the pandemic, the company was building reserves for bad debts, but it began reversing some of these reserves in the 9/20 quarter. This reversal is still going on and the larger credit for bad debts in the 9/21 quarter versus a year ago added about 1.3 cps to earnings growth in the period. To get an idea of how much longer this could go on, we can examine the allowance for bad debt as a percentage of gross receivables which is shown in the table below:

	10/2/2021	7/3/2021	4/03/2021	1/02/2021
Net Receivables	$1,441.2	$1,338.9	$1,301.4	$1,235.2
Allowance for Doubtful Accounts	$37.0	$39.4	$40.7	$44.6
Allowance % of Gross Receivables	2.5%	2.9%	3.0%	3.5%

	9/26/2020	6/27/2020	3/28/2020	12/28/2019
Net Receivables	$1,212.7	$1,114.6	$1,222.5	$1,212.2
Allowance for Doubtful Accounts	$45.8	$46.4	$46.3	$27.1
Allowance % of Gross Receivables	3.6%	4.0%	3.6%	2.2%

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Net Receivables	$1,224.2	$1,232.0	$1,198.7	$1,189.7
Allowance for Doubtful Accounts	$25.0	$23.4	$22.1	$21.1
Allowance % of Gross Receivables	2.0%	1.9%	1.8%	1.7%

The allowance percentage rose from the 2% range before the pandemic, peaked at 4% in the 6/20 quarter, and has steadily declined since. With the percentage back down to 2.5%, we could see another quarter benefiting from either another credit or at least lower than usual provision expense. However, beginning in the 3/22 quarter, the tailwind could shift to a headwind as a normal provision expense should return and compare unfavorably to the sizeable credits in the 4/21-9/21 quarters. We don't have pre-pandemic provision data, but just a return to provision expense of just 0.5% of sales would be roughly $11 million which would equal approximately 10 cps in headwind by itself.

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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.