

Avery Dennison EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	4-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "-" sign indicates deterioration

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

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

AVY beat the consensus estimates by 41 cps in the 9/20 quarter. While lower stock-based compensation and a lower tax rate could have accounted for more than 15 cps of that upside, there is still a sizeable beat left after considering that.

What deteriorated?

- Stock-based compensation expense fell by more than 12 cps in the quarter. We do not view this as sustainable and consider it a low-quality source of profit growth. However, the benefit relative to the size of the earnings beat tempers our level of concern.
(Concern level: MEDIUM)
- The adjusted non-GAAP tax rate fell to 23.6% from 24.1% a year ago. The company has guided for a 24% annual rate and we assume the tax rate was likely below most analysts' models. We estimate the decline added about 5 cps to earnings in the period. Again, given the size of the beat, we are not overly concerned.
(Concern level: LOW)

What improved?

- Inventory DSI rose by just 1.5 days versus the year-ago level with all of the increase due to raw materials. AVY let inventory levels build in the previous two quarters to assure adequate stocks to meet COVID-induced demand and they have now returned to a level near the historical norm.

What to watch

- AVY has taken restructuring charges in the last several years. However, we have not flagged these as a significant concern given the relatively small size and the fact that they are mostly tied to specific severance programs. We will continue to monitor the charges for change in scope and composition.

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.

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