BEHIND THE NUMBERS
Quality of Earnings Analysis
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Avery Dennison Corporation (AVY)
Earnings Quality Update- 12/21 Qtr.

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

We are downgrading our earnings quality rating of AVY to 3- (Minor Concern) from 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 $2.13 which was a penny ahead of the consensus. A lower tax rate accounted for almost all of the upside. In addition, we noted several other low-quality benefits that are unlikely to repeat which prompt us to lower our EQ rating.

- We highlighted last quarter how AVY's results benefitted from a decline in the provision for sales returns. Sales return provision expense in the 12/21 quarter was again down by almost $4 million from the year-ago period, falling to 0.44% of sales from 0.67%. We estimate that the decline as a percentage of sales added 4.8 cps to earnings growth in the quarter. (See below for supporting details.)

- Other non-operating expense/(income) adjusted for pension plan settlement losses in both periods swung by a positive 3.4 cps in the 12/21 quarter versus the 12/20 quarter. AVY no longer discloses pension detail by quarter but we note that for the full year, pension cost declined by more than 6 cps after removing the settlement losses largely due to an actuarial gain versus a loss last year. We suspect that this accounted for much of the beneficial swing in other non-operating expense/(income) in the quarter given the non-service component of pension expense is included in this line item.

- Lower stock compensation expense added 1.7 cps.

- The 2022 outlook calls for growth to be back-loaded due to difficult comps, higher pricing that has yet to catch up to higher costs, and negative currency effect. Also, the company highlighted an increase in investment in intelligent labels, digital capabilities, and sustainability efforts for 2022 which is up from $25 million in 2021. Note that consensus non-GAAP EPS for the 3/22 quarter is currently $2.19 which is a 3.4% decline from a year ago.

- Sales in foreign jurisdictions account for roughly 75% of AVY's revenues which leaves the company exposed to negative FX movements. Currency translation shaved 3.4% off of sales growth in 2021 and the company is forecasting a 3% headwind for sales in 2022.

Sales Return Provisions Fall Again

We documented in our review of AVY's 9/21 quarter that provision expense for sales returns fell versus the year-ago quarter adding 3.7 cps to EPS growth. This benefit continued into the 12/21 quarter as seen in the following table:

	1/1/2022	10/2/2021	7/3/2021	4/03/2021
Sales	$2,183	$2,072	$2,102	$2,051
Implied Provision for Sales Returns	$9.5	$10.7	$9.4	$10.8
Sales Returns as % of Quarterly Sales	0.44%	0.52%	0.45%	0.53%

	1/02/2021	9/26/2020	6/27/2020	3/28/2020
Sales	$1,991	$1,729	$1,529	$1,723
Implied Sales Returns	$13.3	$12.2	$7.3	$10.9
Sales Returns as % of Quarterly Sales	0.67%	0.71%	0.48%	0.63%

We remind readers that AVY discloses the impact of sales return provisions and provision for credit losses on the same line in its cash flow statements. It discloses the provision for credit losses in a separate disclosure on allowance for doubtful accounts. We calculate the sales return provision as the difference between the two. We can see that the provision fell to 0.44% of sales in the 12/21 quarter compared to 0.67% in the comparable year-ago period. We estimate that if the provision has remained a comparable percentage of sales, it would have shaved 4.8 cps off of EPS growth in the quarter. The comparisons will begin getting more difficult in the 3/21 quarter which will likely see a significant boost to recent earnings growth disappear.

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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