BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

Companies in this Issue

Altria Group, Inc. (MO)
Update on recent event

We believe investors should take note of Altria's (MO) efforts to diversify away from cigarettes. It borrowed and spent $12.8 billion to buy a 35% stake in JUUL. Shortly after that, the FDA raised the age to buy JUUL products to 21 and banned where it could be sold and some flavorings. MO now has exposure to JUUL lawsuits and values its JUUL stake at only $350 million after announcing it may pursue other products that compete against JUUL. Its deal with Philip Morris for heated tobacco was halted by the Federal Trade Commission for violating patent rights of Reynolds Tobacco and MO had spent considerable funds rolling out that product in 2020 and

2021. It borrowed and spent $1.9 billion to buy a stake in Cronos a Canadian pot company also. It had already cut the carrying value of that investment to $416 million and announced this week that is abandoning its warrant to buy a larger share of Cronos. It expects to take a $483 million loss on the warrant.

National Instruments Corporation, Inc. (NATI)
Update on recent event

We have followed National Instruments (NATI) for a while and touted several aspects of its conservative accounting while featuring it as a Top Value on our Focus List. NATI was making acquisitions that were growing and in areas of high growth potential plus were in its own areas of expertise – all of which makes it much easier to be successful with deals than focusing only on cost reductions. Efforts to streamline at NATI were quick programs lasting a few months rather than years. NATI was hit by semiconductor shortages in early 2021, causing sales to fall and backlog to build. During that time, margins were squeezed as NATI continued to spend the same amounts on R&D and SG&A, which we regarded as conservative and smart long-term investing in the business. We forecasted that the backlog would result in several quarters going forward where NATI would meet all current demand plus some of the backlog allowing sales to grow and margins to expand. Emerson Electric noticed the potential value here this week and announced a bid for NATI at $53 vs. the $37 stock price.

PVH Corp. (PVH)
Earnings Quality Review

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

We are initiating earnings quality coverage of PVH with a 3- (Minor Concern) rating.

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

Summary

PVH's non-GAAP adjustments to earnings look one-time in nature and have remained high quality. For a company projecting to grow sales by 40% and its operating margin 500bp by 2025 the stock looks cheap at 10x adjusted EPS and 6.9x EBITDA. However, we see too many headwinds in working capital and some key costs to get overly excited in the near term. Recent results may have also benefitted from elevated receivables and cuts to chargebacks and accruals. However, longer-term investors may have an interest in putting the company on their watch lists. Pay attention to royalty levels and sales accruals in particular.

What Is Strong:

- PVH is retiring shares as part of its 2025 plan which is helping EPS growth. The goal is to spend $1 billion in this area. One caution is current cash flow is negative due to working capital growth and PVH has been spending down its cash balance:

	3Q22	fisc 21	fisc 20	fisc 19
Share Count	65.1	70.6	71.1	73.2
Repurchases	$343	$361	$117	$341

- PVH's adjustments to non-GAAP EPS look like one-time items such as impairments to goodwill, transaction costs for buying/selling assets, and debt issuance costs. When it restructures operations the focus is limited in scope, does not last for years, and also looks like one-time items such as right-sizing real estate, closing the Russian unit, or reducing headcount. We do not see PVH adding back stock compensation or amortization, and it even pulls out actuarial changes on pension plans for non-GAAP. **(See below for details)**

- PVH is boosting its advertising spending. That is a good point for earnings quality. This may continue to be a headwind for future growth as PVH has said repeatedly that the industry is overstocked with inventory and it expects a more promotional environment. This is only reported annually.

	fisc 21	fisc 20	fisc 19	fisc 18	fisc 17
Advertising	$535.8	$379.0	$509.7	$526.0	$501.3
Adv. % Sales	6.1%	5.6%	5.4%	5.7%	5.9%

What Is Weak:

- PVH is picking up considerable EPS by cutting its accruals for chargebacks and inventory mark-downs for retailers. These are normal charges that often result from damaged or out-of-season merchandise being sold at a discount as the weather changes. This is only reported on an annual basis, but the amount of expense has fallen nearly in half in 2021 and 2020. It makes sense in 2020 - that was Covid and sales were down overall. But this should start rising again in our view given how low the allowance has become:

	fisc 21	fisc 20	fisc 19	fisc 18	fisc 17
Start of Yr	$165.1	$220.2	$226.8	$271.0	$289.5
Expense taken	$266.9	$264.9	$529.3	$403.8	$498.2
Allowance used	$298.3	$320.0	$535.9	$448.0	$516.7
End of Yr	$133.7	$165.1	$220.2	$226.8	$271.0

This was often a $500 million expense against sales annually. It was only $267 million in 2021 and the size of the allowance has dropped for five years in a row. In 2021, PVH's EPS was $10.15 – every $50 million in this expense that did not occur generated 59 cents in EPS.

- Bad debt reserves are also declining. We understand Covid took this figure up substantially. But, PVH did not book any expense in this area in 2021 and is working down the reserve. At the end of 3Q22, the reserve was down to $50.9 milion, so this may still be a non-quality source of EPS in 2023. Every $5 million PVH does not have to book in expense is about 6 cents in EPS:

	fisc 21	**fisc 20**	**fisc 19**	**fisc 18**	**fisc 17**
Start of Yr	$69.6	$21.1	$21.6	$21.1	$15.0
Expense taken	$0.0	$58.0	$5.7	$14.2	$7.5
Allowance used	$7.7	$9.5	$6.2	$13.7	$1.4
End of Yr	$61.9	$69.6	$21.1	$21.6	$21.1

- Receivables are rising even as sales decline. DSOs hit 40 after 3Q22, and have been running 4-5 days above pre-Covid levels. With sales falling, this looks like they are having back-loaded quarters. This could impact the bad debt reserves just mentioned. PVH also sees FX headwinds for 2023 getting worse creating more pressure on sales. **(See below for details)**

- Inventories are also rising rapidly and have consumed nearly $600 million in cash flow in 2022 so far. DSIs are up over 30 days y/y the last two quarters. We think there are signs the sales are not coming in and even PVH admits the whole industry is carrying too much inventory. Gross margin is already falling even though PVH uses FIFO and Average-Cost policies that help during inflation. With PVH expecting more promotional pressures from competitors and some commodity costs starting to fall, there may be a real risk of PVH having to lower selling prices as it sells inventory built up during rising inflation. That would really pressure gross margins. **(See below for details)**

What to Watch

- PVH collects royalties and advertising payments for its name brands. These look modest at only 5% of total revenues, but they have no cost. Therefore, they generate a high percentage of PVH's total income and free cash flow. A 10% change in royalty revenues is about 45-50 cents in annual EPS.

	3Qs 22	3Qs 21	fisc 21	fisc 20	fisc 19	fisc 18	fisc 17
Sales	$6,182	$6,410	$8,724	$6,799	$9,400	$9,154	$8,439
Royalty/Adv Inc.	$353	$315	$431	$334	$509	$503	$475
Total Rev.	$6,536	$6,725	$9,155	$7,133	$9,909	$9,657	$8,915
% of Revenue	5.4%	4.7%	4.7%	4.7%	5.1%	5.2%	5.3%
NonGAAP EBIT	$642	$809	$984	($37)	$931	$971	$864
Royalty/Adv Inc	$353	$315	$431	$334	$509	$503	$475
% of Income	55.0%	38.9%	43.8%	n/a	54.7%	51.8%	55.0%
Free Cash Flow	($471)	$413	$803	$471	$675	$473	$286
Royalty/Adv Inc	$353	$315	$431	$334	$509	$503	$475
% Free Cash Flow	n/a	76.4%	53.7%	70.9%	75.4%	106.3%	166.2%

It doesn't appear that investors should expect the royalty percentage to rise, but it seems if volumes are under pressure due to inflation and consumers being more cautious, the total amount collected as royalties could decline slightly. We also see in the growth plan that PVH wants to post its highest sales gains from selling more directly to consumers and via digital sales. That may be more profitable than selling via wholesaling to retailers. However, how do they collect a 100% profit royalty on that? Could those plans of selling directly also negatively impact the amount of merchandise retailers want to buy and pay royalties to PVH? We have seen from retailers that they too want to be the destination for certain brands and not one of fifty outlets carrying the same product.

- PVH's net debt is higher than the 1.6x EBITDA it appears to be. PVH has stretched payables to 119 days because its suppliers can factor some of PVH's payables and get paid. The days payable is almost double pre-Covid levels. We believe higher interest rates in the market make these suppliers pay real money now for factoring vs. 15-20bp in interest discounts during 2020-21. PVH is already seeing payables not grow as fast as inventories now. It has $575 million of payables sold. If that is viewed as debt – the company's ratio could be 2.5x EBITDA excluding the cash on hand which is dwindling already to cover working capital build and share repurchases. **(See below for details)**

- Higher discount rates triggered a $417 million impairment of goodwill in 3Q22. This impairment test is done at the beginning of the 3Q each year (August). We would note that since then, the FED has raised rates another 150bp and is guiding to more. Here is what PVH said about its impairment:

  > *"The impairments were driven primarily by a significant increase in discount rates. The impairment charges, which related to the Calvin Klein Wholesale North America, Calvin Klein Licensing and Advertising International and Tommy Hilfiger Retail North America reporting units, were recorded to the Company's segments as follows: $162.6 million in the Calvin Klein North America segment, $77.3 million in the Calvin Klein International segment and $177.2 million in the Tommy Hilfiger North America segment."*

  We think it worth noting that the impairments impacted the brands that PVH highlights as its growth vehicles. Also note that PVN still has $2.2 billion in goodwill and $3.1 billion in tradenames and other intangibles on the balance sheet that should be subject to higher discount rates going forward.

- A strong US dollar is a headwind for PVN as it looks to sell product in foreign countries where they are purchasing from PVN in dollars. That is supposed to be a big part of the future growth plan too. Here are the comments from the 10-Q and guidance:

  > *"There also is a transactional impact of foreign exchange on our financial results because inventory typically is purchased in United States dollars by our foreign subsidiaries.* ***Our results of operations will be unfavorably impacted during times of a strengthening United States dollar, as the increased local currency value of inventory results in a higher cost of goods in local currency when the goods are sold,*** *and favorably impacted during times of a weakening United States dollar, as the decreased local currency value of inventory results in a lower cost of goods in local currency when the goods are sold. We use foreign currency forward exchange contracts to hedge against a portion of the exposure related to this transactional impact."*
  > ***"We currently expect our 2022 net income to decrease by approximately $25 million due to the transactional impact of foreign currency****. Given the current exchange rates, particularly the euro,* ***we also expect our 2023 net income to decrease due to the transactional impact of foreign currency, and by a greater amount than in 2022, with an expected negative impact to our 2023 gross margin of approximately 100 basis points."***

- PVH has enjoyed a below-normal tax rate for several years. This has been the result of changing tax methods, changing estimates on tax positions and the writedown of goodwill in 2020. Plus, it has some income in lower-taxed countries. Historically, the effective tax rate has been in the mid-teens. They are now guiding to 24%.

- Prepaid expenses and other assets are up a significant amount. This is hurting cash flow for 2022 so far. It is possible these are related to hedges for raw materials, fuel, and FX. PVH tries to hedge some of this exposure to help inventory costs and offset FX losses when the dollar is strong.

	10/30/2022	7/31/2022	5/01/2022	1/30/2022
Prepaid Expenses and Other	$210	$207	$201	$169
Prepaid Expenses and Other Days	8.4	8.9	8.6	6.3

	10/31/2021	8/01/2021	5/02/2021	1/31/2021
Prepaid Expenses and Other	$150	$157	$168	$158
Prepaid Expenses and Other Days	5.8	6.2	7.3	6.9

	10/30/2022	7/31/2022	5/01/2022	1/30/2022
Other Current Assets	$164	$150	$154	$128
Other Current Assets Days	6.5	6.4	6.6	4.8

	10/31/2021	8/01/2021	5/02/2021	1/31/2021
Other Current Assets	$94	$77	$68	$50
Other Current Assets Days	3.7	3.0	3.0	2.2

This is worth watching going forward. The cost of the contracts have not been expensed into the income statement yet. If some of the inflationary trends reverse more, when these hedges roll through the income statement, they could produce losses when expensed. PVH does not adjust out these costs in non-GAAP results and losses could dampen gross margins too.

Working Capital Concern - Receivables

Receivables are at record highs. At the same time, sales are declining y/y. This has been the case for the last two quarters. This has the appearance of back-loaded quarters where sales are occurring in the last few days and still sales growth is slowing. The receivable growth is not discussed in the recent conference calls. The following table shows DSOs for the last 16 quarters:

	10/30/2022	7/31/2022	5/1/2022	1/30/2022
Revenues	$2,281	$2,132	$2,123	$2,430
Trade Receivables	$1,002.3	$837.5	$872.5	$765.3
Trade Receivables Days of Sales	40.0	35.7	37.4	28.7
	10/31/2021	8/1/2021	5/2/2021	1/31/2021
Revenues	$2,333	$2,313	$2,079	$2,090
Trade Receivables	$936.6	$847.2	$883.3	$666.6
Trade Receivables Days of Sales	36.5	33.3	38.7	29.0
	11/01/2020	8/2/2020	5/3/2020	2/2/2020
Revenues	$2,118	$1,581	$1,344	$2,601
Trade Receivables	$818.7	$596.2	$566.9	$765.1
Trade Receivables Days of Sales	35.2	34.3	38.4	26.8
	11/03/2019	8/4/2019	5/5/2019	2/3/2019
Revenues	$2,588	$2,364	$2,356	$2,484
Trade Receivables	$998.8	$808.9	$876.0	$803.8

Sales rebounded strongly after Covid in 2021. PVH does talk about having some tough comps, but sales still aren’t back to pre-Covid levels. Also in 3Q22, sales fell 2.2% y/y and fell 7.8% in 2Q22. Also notice that receivables DSOs are up 4-5 days from pre-Covid levels and are up even from the rebound quarters. Rising receivables have been a $300 million headwind for cash flow in 2022.

PVH does talk about FX headwinds hurting sales growth. We think this is a bigger issue than merely having to convert a foreign currency into dollars. The real issue is PVH is raising prices due to inflation and with FX, it is trying to convince a foreign customer to effectively pay $100 for a shirt that cost $60 a year ago. Many are likely not buying or buying one shirt instead of three. That is a bigger loss of sales than FX conversion.

PVH may still reach its goal of $12 billion in sales in 2025 vs. the current $9 billion, but high receivables already looks like channel stuffing or back-loaded quarters, and they are guiding to weak sales in the 4Q and saying 2023 will see more pressure from FX.

Working Capital Concern - Inventories

Inventories call into question several issues at the moment for PVH. Inventory levels have consumed nearly $600 million in cash flow so far in 2022. Under Covid, when many stores were closed, there were quarters when inventory backed up on PVH – DSI's topped 200 days. These levels were quickly sold down in 2021 and it wasn't a series of markdowns. The last markdown was only $29 million in 2019. The following table shows inventory DSIs for the last 16 quarters:

	10/30/2022	7/31/2022	5/1/2022	1/30/2022
Total Inventory	$1,821.2	$1,689.9	$1,389.7	$1,348.5
DSI	164.6	168.5	143.1	121.1
	10/31/2021	8/1/2021	5/2/2021	1/31/2021
Total Inventory	$1,379.6	$1,421.3	$1,450.9	$1,417.1
DSI	127.1	132.0	155.3	133.8
	11/01/2020	8/2/2020	5/3/2020	2/2/2020
Total Inventory	$1,483.5	$1,642.2	$1,561.2	$1,615.7
DSI	132.8	214.3	209.5	122.2
	11/03/2019	8/4/2019	5/5/2019	2/3/2019
Total Inventory	$1,768.1	$1,862.1	$1,608.4	$1,732.4
DSI	136.2	157.5	138.0	139.7

Higher cost of goods sold reflects the inflation impacts of PVH having to pay more for inventory too and mitigates the DSI figure. DSIs are still at record non-Covid levels. The third quarter is normally 130-135 days and just came in at 165. We do not give much weight to arguments about supply chain shortages when a company can add 30 days of inventory. Here are some of the problems even PVH is saying about inventory in the 10-Q:

- They may find it tough to raise prices to offset inflation – due to, *"inflationary pressures have **slowed consumer demand** for our products, as **consumers reduce discretionary spend and certain of our wholesale customers take a more cautious approach**."* And, *"We also expect the increased promotional environment in all channels to continue due to elevated inventory levels industry-wide compared to consumer demand."*

- ***"Our cash flows for the remainder of 2022 may be subject to material significant change, including as a result of elevated inventory levels*** *that we may experience due to lower consumer demand for our products as a result of inflationary pressures."*

- Gross margins are already coming down. It's also important that PVH uses FIFO and average-cost inventory methods that should help margins during inflation. Add to that, inventory is 5-6 months now. If inflation reverses, will margins be under more pressure as it sells products acquired at higher costs with pressure on pricing?

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Gross Margin	55.9%	57.2%	58.4%	58.3%	57.7%	57.7%	59.1%	53.9%

In the 10-Q, PVH blames the decay on inflation pushing up inventory and procurement costs, high inventory levels industry-wide causing greater promotional activity, and a strong US dollar.

- In the 10-Q, PVH guides to more gross margin pressure for the same reasons: ***"We currently expect that gross margin for the fourth quarter of 2022 will decrease as compared to 2021 in line with the gross margin decline in the third quarter of 2022 compared to 2021."***

Working Capital Concern – Payables and Debt

Accounts Payable levels are ballooning even faster than inventories. Payables are nearly double the Pre-Covid totals. Since they already took off much sooner, this is not helping cash flow nearly as much as receivables and inventories are draining it. Payables only added $56 million to cash flow through nine months of 2022 vs. nearly $900 million of cash drain from receivables and inventories. The following table shows days payable for the last 16 quarters:

	10/30/2022	7/31/2022	5/1/2022	1/30/2022
Accounts Payable	$1,314.3	$1,359.0	$1,062.2	$1,220.8
Accounts Payable Days	118.8	135.5	109.3	109.6
	10/31/2021	8/1/2021	5/2/2021	1/31/2021
Accounts Payable	$1,051.3	$1,069.5	$1,023.8	$1,124.2
Accounts Payable Days	96.9	99.4	109.6	106.2
	11/01/2020	8/2/2020	5/3/2020	2/2/2020
Accounts Payable	$1,134.4	$1,048.2	$783.9	$882.8
Accounts Payable Days	101.5	136.8	105.2	66.8
	11/03/2019	8/4/2019	5/5/2019	2/3/2019
Accounts Payable	$780.5	$930.2	$696.2	$924.2
Accounts Payable Days	60.1	78.7	59.7	74.5

One of the reasons payables are so high is PVH set up a financing program to allow vendors to sell their PVH receivables to banks and collect some cash earlier. At the end of 3Q22, $575 million had been sold through this program. PVN still carries these payables on its balance sheet. There are several potential risks we see here:

- Until recently, a program like this had minimal cost. It was likely only a few basis points and the suppliers didn’t mind paying that. Now, they may be paying 400-500bp to factor what PVH owes them.

- We think that rising cost may be passed on to PVH. That could have a negative impact on gross margin for PVH.

- A program like this may have a limit too – PVH may not be able to tap it much further to stretch payables even more and produce cash flow. It’s possible PVH may actually need to reduce payables going forward and have this become a cash drain.

- This makes debt higher in our view than it appears to be. Looking at the balance sheet, PVH reports debt of $2.24 billion and cash of $457 million. Trailing adjusted EBITDA of $1.12 billion makes debt look like it's only 1.6x. However, we know $575 million of payables are being factored and the trade could require faster payment. That would make debt $2.82 billion and with the company’s working capital consuming cash and overstock through the industry hurting margin – should the cash even be taken out at this time? Debt could actually be closer to 2.5x EBITDA.

GAAP vs Non-GAAP Adjustments Look Tame

On the surface, the income and adjusted income statements look closely aligned except in 2022 and 2020. The GAAP results show a couple of goodwill impairments and are inclusive of restructuring charges and transaction charges often expected when a company grows through a series of acquisitions.

GAAP Results	3Qs 22	3Qs 21	fisc 21	fisc 20	fisc 19	fisc 18	fisc 17
Sales	$6,182.4	$6,410.0	$8,723.7	$6,798.7	$9,400.0	$9,154.2	$8,439.4
Royalty/Adv Inc.	$353.1	$315.0	$431.0	$333.9	$509.0	$502.6	$475.4
Total Rev.	$6,535.5	$6,725.0	$9,154.7	$7,132.6	$9,909.0	$9,656.8	$8,914.8
Gross Profit	$3,732.4	$3,907.8	$5,324.1	$3,776.8	$5,388.4	$5,308.3	$4,894.4
SG&A Exp.	$3,194.8	$3,198.7	$4,453.9	$3,983.2	$4,715.2	$4,432.8	$4,245.2
Goodwill Impairment	$417.1			$933.5			
N/Serv Pen Inc.	-$10.2	-$11.5	-$64.1	-$75.9	$90.0	$5.1	$3.0
Debt modif cost					$5.2		$23.9
Equity Income	$42.6	$14.1	$23.7	-$4.6	$9.6	$21.3	$10.1
GAAP EBIT	$173.3	$853.6	$1,076.9	-$1,071.7	$558.7	$891.7	$632.4

Getting to non-GAAP results involves one-time items and a few recurring ones. What we like is PVH does not add back stock compensation. It has witnessed some very minor inventory write-downs but that hasn't happened recently. Below is a list of these items. Inventory issues impact gross margin and several others impact SG&A:

	3Qs 22	3Qs 21	fisc 21	fisc 20	fisc 19	fisc 18	fisc 17
GAAP EBIT	$173.3	$853.6	$1,076.9	-$1,071.7	$558.7	$891.7	$632.4
Inv. Markdowns					$29.4	$2.2	
SG&A Acq/Divest		$26.6	$26.6	$29.0	$62.6	$23.6	$164.0
SG&A Restructuring	$16.7	$47.6	$47.6	$118.2	$144.9	$38.5	$27.2
SG&A debt Issue exp					$1.0		$4.2
SG&A Russia exit	$50.5						
Pension items			-48.7	-$61.5	$97.8	$15.0	$11.9
Debt Modif/Issue					$5.2		$23.9
Gain/Impairment	-$16.1	-$118.9	-$118.9	$15.4	$142.0		
Goodwill Impair.	$417.1			$933.5			
Non-Cash Mark up					-$111.0		
Non-GAAP EBIT	$641.5	$808.9	$983.5	-$37.1	$930.6	$971.0	$863.6

- There is a recurring lumpy acquisition or asset sale transaction cost that occurs in many years. We are not disturbed by this as each relates to a different deal. However, we would tell investors to expect this to recur and some of these charges consume cash.

- Restructuring is the same thing. This runs the gamut of closing and relocating a duplicate headquarters building to laying off staff and closing stores to right-sizing warehouse and logistical spaces. We give PVH credit in that these do not appear to be 5-7 year plans like we see with other companies, they are short-lived and unique items. However, some of this consumes cash too.

- The pension items that are not in SG&A reflect the non-service cost part of pension income/expense. These include interest expense and return on investments. It also includes changes in assumptions for those items and actuarial gains that result in those areas. GAAP earnings reflect the one-time, often material actuarial gains. Non-GAAP is more conservative and pulls out the actuarial gains.

- Gains/Losses have occurred with the sale of assets related to Heritage and Speedo. There have been impairments with equity income investments. We did see an Australian unit in fiscal 2019 that had asset values increase. The Non-GAAP earnings backed all that out.

- In our opinion, the adjustments to non-GAAP earnings do not look nearly as aggressive as we see elsewhere. There is no amortization added back and stock compensation is not added back. Many aspects of them are one-time in nature, but investors should be aware that some of these items negatively impact cash flow:

	3Qs 22	3Qs 21	fisc 21	fisc 20	fisc 19	fisc 18	fisc 17
Cash from Ops	-$275.7	$583.2	$1,071.2	$697.7	$1,020.3	$852.5	$644.2
Capital Spend	$194.8	$170.7	$267.9	$226.6	$345.2	$379.5	$358.1
Free Cash Flow	-$470.5	$412.5	$803.3	$471.1	$675.1	$473.0	$286.1
GAAP income	$61.7	$561.5	$952.3	-$1,136.1	$417.3	$746.4	$537.8
NonGAAP income	$442.2	$528.4	$729.1	-$139.9	$711.3	$742.4	$624.4
NonGAAP EPS	$6.60	$7.31	$10.15	-$1.97	$9.54	$9.60	$7.94

- The biggest differences between GAAP and nonGAAP income are goodwill write-offs in 2022 and 2020.

- The negative cash flow in 2022 involves working capital we discussed above.

The Procter & Gamble Company (PG)
Earnings Quality Update

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 3- (Acceptable)

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

Summary of the Quarter

PG's EPS of $1.59 for the second fiscal quarter ending in December was in-line with Wall Street estimates. However, a lower tax rate could have added almost 2 cps and a decline in depreciation and amortization expense added another penny, so we see this as a miss. Items to note:

- The tax rate fell to 18.1% in 2Q23 from 19.1% a year ago. The company was guiding to a 19.5% rate for the full year after the 1Q23 quarter in which it posted a 20.7% rate. We believe this makes it likely that analysts would have been expecting at least a 19% rate in 2Q23 which implies a 1.8 cps unexpected benefit to EPS in the quarter.

- Depreciation and amortization fell by $31 million YOY in the quarter. This decline added about a penny per share to earnings. PPE fell in 1Q23, but it has started to increase again in 2Q23. The decline in depreciation should reverse in upcoming quarters.

- Payable days fell to 119 from 122 last year. The company blamed its lower free cash flow productivity figure on its "temporary reduction in payables" which we assume relates to a decline in usage of its supply chain financing program. We have warned that suppliers are likely to utilize these facilities less as interest rates rise which will reel in expanding payables balances and crimp cash flow growth in the process.

- The company avoided a write-down in its Gillette goodwill although it noted that fair value remains only about 5% above carrying value as of 12/31/22. It also noted in its sensitivity analysis in the 10-Q that a 25 bps increase in the discount rate or a 25 bps reduction in the growth rate would cut the fair value by 6%. If rates continue to increase and/or growth in shave care remains weak, we could see more impairments in upcoming quarters.

- PG does not quantify the exact advertising spend but noted that marketing spending declined in the quarter and fell by 90 bps as a percentage of sales due “primarily to the positive scale impacts of the organic sales increase.” However overhead costs increased which the company attributed to wage inflation and other cost increases. Given that there was likely inflation in advertising functions as well means that marketing activity was down more than the numbers indicate. The company boasted of market share increases in the quarter and elasticity remains impressive. Management said in the call that elasticities are stronger than anticipated everywhere except Europe. Despite price increases of 10%, organic volume was down 6%. However, the company contends after adjusting for a 1% negative impact from cutting the Russian portfolio and a 2% impact from “temporary inventory reductions” by retailers, volume was down by only 3%. Even so, rising advertising seems likely to become a headwind in upcoming quarters.

- PG’s outlook for the quarter called for the headwind from raw materials, freight, and FX for the full year to fall to $1.50 per share, down from its $1.57 forecast at the end of 1Q23. However, it also raised its tax rate outlook from 19.5% to 20.0% which would result in almost 4 cps in headwinds resulting in a 3 cps net improvement in the outlook. The company left its EPS outlook unchanged at 0-4% growth but as it did after 1Q23, it cautioned it is likely to be at the bottom of that range.

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

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