BEHIND THE NUMBERS
Quality of Earnings Analysis

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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Behind the Numbers

Companies in this Issue

AT&T Inc. (T)
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 T of 5+ (Strong).

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

Summary

AT&T's non-GAAP EPS of $0.61 beat forecasts in 4Q22 by 4 cents. The adjustments were largely adding back a goodwill impairment for Business Wireline and non-cash adjustments related to pension actuarial gains/losses. AT&T hit Free Cash Flow forecasts for 2022 at $14.1 billion. We saw several positives in the report:

- The forecast for 2023 is for higher Free Cash Flow of $16 billion – despite capital spending holding at $24 billion and cash taxes as a $1 billion headwind plus $1 billion in lower DirecTV payments. Working capital (particularly receivables) was a headwind in 2022. AT&T is forecasting lower acquisition costs in 2023 which means the income statement is hurt by the amortization of prior costs, but that is a non-cash item so cash flow should increase. After 2023, capital spending is expected to decline. Also, AT&T believes BEAD funding (Broadband Equity Access and Development program) may start to contribute to cash flow in 2024.

- AT&T exceeded its guidance for cost-cutting, reaching a run-rate of $5 billion per year vs. forecasts for $4 billion. It expects to hit $6 billion by the end of 2023. This should continue to be a strong tailwind into 2024. While AT&T ended the year at a $5 billion run rate, it started 2022 at a run rate of just over $3 billion, thus it probably saw about $4 billion in actual benefit during 2022.

- AT&T raised its bad debt reserves in 2Q22 by $130 million when it saw DSOs stretching out two days. That seems to have corrected itself with bad debt reserves falling $58 million sequentially – adding 0.6 cents to 4Q22 EPS.

- There was another bump from selling $90 million in intellectual property at the Business Wireless unit vs. $75 million the year before. That is a fairly minor EPS tailwind, and that unit remains the most troubled **(See below for details).**

- AT&T sees headwinds of 25 cents for 2023 adjusted EPS of $2.35-$2.45 vs. 2022's $2.57. A higher tax rate is expected to be a 5-cent headwind, 20 cents of headwind is expected from higher interest rates boosting pension expense, and there should be less interest capitalized in 2023 due to spectrum going into service. The 20 cents should be non-cash. AT&T does not foresee any cash contributions to the pension in 2023.

- ARPU and customers are rising at both wireless and broadband. Forecasts are for 4%+ and 5%+ growth respectively. More importantly, AT&T is seeing higher margin incremental revenue in that growth. Roaming fees for example in wireless ARPU as well as adding family members to phone plans via FirstNet require less marketing and set-up costs. Early broadband users require heavy investment, but adding the 1000th customer vs. the 1st involves much lower cost as the 1000th and 1st pay the same revenue.

ARPU	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Post-Paid Phones	$55.43	$55.67	$54.81	$54.00	$54.06	$54.37	$54.24
Fiber Broadband	$60.31	$58.63	$57.64	$56.66	$55.96	$55.16	$54.76

- Debt is down to 3.2x EBITDA to end 2022. It should decline to about 2.9x in 2023 assuming $8 billion in paydown, and the company expects to reach its target of 2.5x in early 2025.

What to Watch

Business Wireline Remains a Work-in-Progress

In the 4Q, AT&T took a $24.8 billion goodwill write-off for Business Wireline. That was a combination of higher discount rates to do the valuation test and the continued secular decline in that unit.

Business Wireline saw almost flat results on EBTIDA again in 4Q. There was a $90 million sale of intellectual property in 4Q22 vs. $75 million in 4Q21 that helped. That is lumpy just like the $100 million sold in 3Q22 was.

Business Wireline	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Revenue	$5,635	$5,668	$5,595	$5,460	$5,901	$5,938	$6,052
EBITDA	$2,161	$2,224	$2,023	$2,158	$2,193	$2,306	$2,362

Guidance for 2023 is that Business Wireline should see EBITDA decline in the high-single-digit range. That is actually an improvement as guidance after 2Q22 and 3Q22 was double-digit decay through 2H24.

AT&T is seeing some traction on moving some of the Business Wireline to Firstnet Connections for wireless as well as bundles with 5G and fiber. The goal remains the same- strip more costs out of the unit to stabilize the EBITDA on a smaller revenue figure while at the same time retaining the customers by turning them into 5G and Broadband clients too. The new JV the company announced for Gigapower may be a new twist being added to entice these customers.

International Business Machines Corporation (IBM)
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 IBM of 2- (Weak).

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

Summary

IBM's 4Q22 non-GAAP EPS of $3.60 missed forecasts by 1 cent. The company disappointed with guidance for $10.5 billion for free cash flow that it believes will be backloaded. As usual, we will need to do IBM in two parts as very little information we need to fully review is available in the press release or charts and we need the 10K. We believe 23-35 cents of IBM's adjusted EPS is unsustainable and low-quality so the miss may be a strong precursor to 2023 results:

- The tax rate was 40bp lower y/y adding 1.7 cents in EPS. That may have been a larger source of EPS given that IBM's guidance for 2022 and 2023 is a tax rate in the mid-to-high teens and it was 13.8%. If analysts were expecting 16-17% - then this added 10-14 cents to EPS.

- Stock compensation was down $16 million adding 1.5 cents in EPS.

- R&D was down in dollar terms by $21 million adding 2.0 cents in EPS. This is despite labor inflation and sales growth at IBM overall as it predicts mid-single-digit growth in 2023. As a percentage of sales (excluding financing and other revenue) – the drop in R&D would have added 4.8 cents to 4Q21.

- Depreciation and Amortization was down y/y from $1.38 million to $1.14 million. We know that acquired intangible amortization was $182 million in 4Q21 and $156 million in 4Q22. We know that Kyndryl was still in the mix for one month of 4Q21. In 3Q21, Kyndryl depreciation was $389 million so one month would be $130 million. If we net this out, we believe apples-to-apples depreciation at IBM fell from $1.068 million to $981 million. This added $87 million to earnings or 8.3 cents in EPS.

- We also want to point out for depreciation that IBM announced on the earnings call that it is extending the life of equipment as of January 1, 2023 – so this could be a source of future EPS growth. CFO Jim Kavanaugh stated on the call that "… then third, we regularly review the useful lives of our assets. Due to advances in technology, we are making an accounting change to extend the useful life of our server and networking equipment effective the 1st of January."

- Adjusted SG&A was down $102 million y/y which added 10 cents to EPS. This surprised us as we know that bad debt was increasing, IBM had cut marketing in prior quarters, and the company's comp on workforce rebalancing was a $60 million credit that it booked in 4Q21. We need the 10-K to see those figures for 4Q- picking up 10 cents in SG&A does not look sustainable to us.

- We wondered how the new Z-System roll-out would mature – now we see a large drop against two easy comps:

Z-System Growth	4Q	3Q	2Q	1Q
2022	**16%**	**88%**	**69%**	**-19%**
2021	**-6%**	**-33%**	**-11%**	4%
2020	-18%	-15%	**69%**	**59%**
2019	**62%**	-15%	-20%	-11%

The bold figures are Z-Systems growth, the non-bold figures are the full systems unit's growth rate and Z-Systems were called out as leading the full unit.

- IBM did not call out Kyndryl sales for 4Q22 results. We know throughout 2022, Kyndryl had been a big part of IBM's growth in three areas. All three were ugly in 4Q22. Software was up only 2.8% or 8.0% in constant currency. Transaction Processing was down 3% or up 3% in constant currency. And Infrastructure was up only 1.6% or 7.4% in constant currency. We may know more with KD's results.

- IBM also called that it had $650 million in hedging gains in 2022 that will not recur in 2023. Plus, it expects to take a charge of $300 million in 1Q23 to eliminate more costs.

Kimberly-Clark Corporation (KMB)
Earnings Quality Update

We are maintaining our earnings quality rating of 3+ (Minor Concern)

KMB's 4Q22 EPS of $1.54 topped estimates by 3 cps. From an earnings quality standpoint, unusual benefits were offset by unusual headwinds so we saw the beat as mostly clean. However, we remain concerned that the company may face a hard time maintaining adequate volume growth in the wake of aggressive pricing without significant advertising and promotional spending.

- Lower depreciation and amortization was again a tailwind of 2.4 cps. Net PPE was roughly flat so this benefit should disappear when capex normalizes.

- However, the benefit from lower depreciation and amortization was offset by higher stock compensation of 2.4 cps as the year-ago quarter featured a $4 million credit compared to a more normal $49 million expense in the 12/22 period. Comparisons will begin to normalize next quarter when the company compares to a $16 million expense in the 3/22 quarter.

- A beneficial swing in other income of 1 cps was offset by a 1.2 cps negative move in adjusted non-operating expense.

- The company has now gone an entire year without adding back restructuring plan expenses to non-GAAP earnings in stark contrast to the company's long-term history.

- KMB produced 5% organic growth in the quarter but had to lean hard on pricing in the quarter. A 10% increase in pricing resulted in a 7% decline in volumes. The company is planning on pushing through another round of pricing in the first half of 2023. However, it also admitted that by the end of the year, it was more than fully passing along higher costs in its pricing and stated that the price of key raw materials like pulp had already turned down during the fourth quarter. This may make it even more difficult to continue increasing prices as retail customers know KMB's costs are coming down. We estimate if the company's pricing falls just 1% below its expectations it could cost the company 45 cps in earnings or about 8% of the 2023 estimate.

- Like most staples companies, KMB was able to survive with lower advertising spending during the pandemic. However, with conditions normalized and rising prices crimping consumers, the company is admitting that it will need to increase advertising back to perhaps 2020 levels. KMB only discloses advertising spending on an annual basis and the K is not out yet, but we know advertising was 5% of sales in 2020 and 4.6% in 2021. Depending on the advertising spending in 2022, a 50 bps increase in advertising as a percentage of sales could be more than a 23 cps headwind to growth.

- Management indicated it preferred to support its brands through advertising rather than promotional spending, this may not be realistic given private label's presence. If KMB is required to offer more in the way of payments to retailers to keep shelf space, it could put more pressure on the company's net pricing.

- Although the company stated that it would take a while for lower raw material costs to work their way through the income statement, we would note that with almost 40% of inventory accounted for under LIFO, the benefit should be felt sooner than many of its FIFO peers.

Microsoft Corporation (MSFT)
Earnings Quality Update

MSFT's fiscal second-quarter EPS of $2.32 was 3 cps ahead of estimates. The beat appeared clean to us and there were unusual headwinds including higher stock compensation and a worse-than-expected outcome for mark-to-market of investments. We are therefore maintaining our earnings quality rating of 4- (Acceptable) for now.

- The market did not react well to the deceleration in Azure where the currency-adjusted growth rate fell sharply to 31% from the previous 40% range:

	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Azure Constant Currency Gr.	31%	42%	46%	49%	49%	48%	45%

The company expects Azure growth to weaken further by 4-5% for the discal third quarter.

- Other income/expense was about $160 million worse than the company's outlook after the first quarter. This amounted to an approximate 1.7 cps headwind relative to the earnings target. This was driven by the mark-to-market on investments which by itself was a negative swing of 3.3 cps.

- Stock compensation jumped again, representing an almost 7 cps headwind to growth.

- The latest extension of depreciable lives of network equipment which we discussed in previous reviews added 10 cps to EPS in the quarter. This was already known and factored into forecasts so it was not relevant to the earnings beat. Still, investors should realize that the EPS would have declined by 10.5% without the change compared to the reported 6.5% decline.

- The company announced a $1.2 billion pretax charge mostly related to its planned layoff of 10% of its workforce. This was added back to non-GAAP earnings. MSFT seldom utilizes non-GAAP adjustments and the charge appears to be a contained event so we do not expect meaningful future charges.

- We applaud MSFT for not adding back amortization of acquired intangibles back to non-GAAP earnings. Still, amortization of intangibles amounted to only about 7 cps in the quarter or 3% of EPS which is small versus most other tech firms. However, we do observe that the company allocated over 85% of the value of the Nuance acquisition to goodwill and less than 25% to intangibles. It will be interesting to see the breakout of the upcoming Activision deal.

Texas Instruments Incorporated (TXN)
Earnings Quality Update

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

We are reducing our earnings quality rating of TXN to 4- (Acceptable).

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

Summary

TXN's adjusted EPS of $2.19 beat forecasts by 16 cents. Some areas caught our eye for earnings quality. We believe some of this is transition-related as new plants come online and we want to see the 10-K to fully assess this:

- The restructuring charges relate to start-up costs of the new LFAB that went into production in December. At that time, those assets started to depreciate and the start-up costs would also move to Cost of Goods. In the 4Q, the restructuring fell from $77 million in 3Q to $48 million – that makes sense with the plant going online. However, Depreciation was flat at $249 million from 3Q to 4Q.

- Cost of Goods fell sequentially too with lower sales. However, the drop was only $21 million on a $571 drop in sales. The drop in margin was 320bp. TXN attributed this to LFAB moving to Cost of Goods, and higher recent capital spending – which has been going up: $597 million in 2Q to $798 million in 3Q to $967 million in 4Q. OK – then shouldn't depreciation be rising now? TXN guides to large depreciation growth coming and this may prove to be an aberration. But, we think depreciation should have grown in 4Q22.

- TXN noted it picked up 11 cents in EPS that was not in guidance. This looks like it came from taxes. Guidance was for a 14% tax rate for the year. Through September, the tax rate was running at 14%. In 4Q, it came in at 9.5% and was enough to take the full-year rate under 13%.

- Stock compensation rose y/y in the 4Q from $50 million to $62 million. However, that was the smallest bump all year. The other quarters were gains of $13 million, $16 million, and $18 million.

- Other income is a lumpy line item. It includes royalty income, interest income, and gains/losses on investments. Higher interest rates on cash likely account for the y/y jump of $42 million but there is no discussion on this yet. It added 4 cents to EPS.

What to Watch

- DSOs have now reached normal levels. There was a back-loaded quarter in 2Q with late fulfillment in China.

	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Accts Rec.	$1,895	$2,040	$2,190	$1,795	$1,701	$1,653	$1,591	$1,584
DSO	33	36	38	33	32	33	32	33

- DSIs had a large jump in 4Q. That is by design as TXN wants to keep levels high because obsolescence is a low risk for many products and it avoids missing sales due to out-of-stock situations. It also lets TXN continue to spread high fixed costs over more output units when it continues to produce more inventory than it can sell. Even when inventory was about 120 days, TXN said it did not mind carrying 190 days. This is worth watching as they are predicting lower sales for 1Q23 and noted that customers are drawing down their inventories. On the positive side, TXN believes China reopening could cause demand to increase as 2023 moves forward:

	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
DSIs	160	136	126	128	118	114	113	116
Fin Gds DSI	50	41	36	40	37	37	40	44

TXN is guiding to higher depreciation as new plants come online. They believe it will rise from $1 billion in 2022 to $2.5 billion with annual increases of $0.5 billion. They will need sales growth to turn up to leverage that type of cost increase.

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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