BEHIND THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

Companies in this Issue

AT&T, Inc. (T)
Earnings Quality Update

We are maintaining our earnings quality rating of T at 5+ (Strong).

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

Summary

AT&T's 4Q23 adjusted EPS of 54 cents missed by 2 cents. Approximately 3 cps can attributed to Business Wireline coming in below forecast. Given that the unit has been weak for years and transitioning into the mobility unit and broadband unit we are not overly concerned with that as a source of earnings miss. The longer-term forecast was that it would bottom in 2024 and AT&T largely confirmed that guidance on the call, pointing to a 10% EBITDA decline for 2024.

Free cash flow beat forecasts that were raised twice in 2023, coming in at $16.8 billion. Guidance for 2024 is $17-$18 billion. That was lower than we expected as AT&T had hinted at 2024 reaching about $20 billion due to $4 billion of lower capital spending. However, it now expects the capital spending to fall by about $2 billion from $23.6 billion to $21-$22 billion. This accounts for the bulk of the lower free cash flow forecast.

- Cash taxes were expected to rise in 2024, but now the forecast is for up $1.5 billion in 2024 – that is more than expected.

- AT&T is seeing the opportunity to roll out more fiber quickly in 2024. It is gaining higher profitability on incremental adds and higher ARPUs. It had hinted at having 2024 capital spending at $20 billion in 2024 and now is forecasting $21-$22 billion.

- Management did confirm that without the rapid roll-out of fiber, longer-term recurring capital spending should be about $18-20 billion per year. Thus, the higher spending in 2024 looks like a timing issue driven by good opportunity.

- Unlike early 2023, AT&T does not see a large working capital impact on free cash flow for 2024. That is what really spooked the market in 2023 when free cash flow came in at $1.0 billion in 1Q23 while AT&T confirmed its $16.0 billion full-year forecast.

Debt-to-EBITDA continues to decline and AT&T is comfortable with hitting its forecast of 2.5x in 1H25. It started the year with $132.2 billion of debt and a debt ratio of 3.19x. It paid down debt along with vendor financing in 2023 to $128.9 billion and saw EBITDA grow to the ratio of 2.97x in 4Q23. Guidance is for 3% EBITDA growth, which would drop the ratio to 2.88x without retiring any debt, or 2.68x if AT&T retires $9 billion which would be the Free Cash Flow after the dividend.

We still see this as the steady long-term driver of equity appreciation for AT&T. Debt becoming a smaller part of enterprise value transfers more value to the stock. Every $7.2 billion of debt retirement is worth $1 in share appreciation.

Other headwinds and tailwinds:

- There is still funding from the infrastructure bills for broadband roll-out that can come in for AT&T. This would be incremental free cash flow.

- AT&T paid down a large amount of short-term vendor financing in 2023. This would have paid for some of 2022's and early 2023's capital spending. That should mean that direct new project capital spending in 2024 will go up – helping growth rates.

- AT&T is forecasting another $2 billion in cost savings as it retires copper with lower-cost fiber and moves more people to mobility.

- The incremental adds to existing broadband are more profitable as there is no additional depreciation, capital spending, etc. Also, they come in at the same rates as other customers. The Gigapower work may have a larger impact in 2024 too.

- Capitalized interest is declining as more projects are turned on. That hurts EPS but also boosts earnings quality. It should drop 5 cents in 2024.

- DirecTV payments are expected to continue to decline – that was the forecast from the start and is a 3-cent headwind for 2024.

- Accelerated depreciation will be a headwind through 2026 of about 2 cents per quarter.

Texas Instruments Incorporated (TXN)
4Q 23 Earnings Quality Update

We are maintaining our earnings quality rating of TXN at 4+ (Acceptable).

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

Summary

TXN's 4Q23 EPS of $1.49 beat by 2 cents. However, TXN called out 3 cents worth of benefits in the quarter it had not guided for and therefore the quarter can be seen as a 1-cent miss. TXN did not specify the source of the 3 cents. One thing that jumped out to us was the tax rate was 11.4% vs. guidance of 13%-14% - that alone is 3 cents. There have been some small amounts to recognize actuarial losses/gains with the pension plan in 2023. Some of the benefit could be there but we need the 10-K to see it.

Guidance was the bigger problem for TXN – 1Q24 is expected to be only $0.96-$1.16 on revenues of $3.45-$3.75 billion vs. 4Q23's $1.49 and $4.08 billion in revenue. What's going on?

- China and other end markets are weak as customers reduce inventory on hand after building it up during chip shortages in 2021 and 2022.

- Capital spending has ramped up which in turn is boosting depreciation and squeezing margins amid lower sales.

- TXN views inventory as a strategic asset. It doesn't spoil or degrade in price, the amount of chips per product is rising, customers often need product rapidly, and out-of-stock situations cost it sales and deleverage profitability. At $4 billion and 224 days, TXN's inventory sets off red flags.

- TXN does a much higher percentage of direct sales than its competitors. That requires it to hold more inventory to meet orders rapidly. Compared to competitors with inventory on their balance sheets and in the distributor channel – TXN's inventory looks reasonable.

- TXN always invests in its business and views R&D and SG&A spending more as a dollar amount than a percentage of sales – that means when sales are weak, it squeezes margins and when sales are strong, margins rise.

China and End Markets are Weak and Are Reducing Inventories Built up when Supply was Scarce

TXN End Markets	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
Industrial (40% sales)	-14%/-16%	-4%/-6%	flat	falt	-10%	flat
Auto (34% sales)	-4%/-6%	+ 4%/6%	+ 1%/3%	+ 4%/6%	+ 4%/6%	10%
Personal Elec (15% sales)	flat	20%	+ 1%/3%	-30%	-14%/-16%	-14%/-16%
Communications (5% sales)	-1%/-3%	-17%/-19%	-14%/-16%	-14%/-16%	-20%	+ 7%/9%

- China-based demand has remained weak in 2024.

- In four of these six quarters, TXN noted that customers were bringing down inventories as part of the correction from double and triple ordering when chips were in short supply in 2021. *(More on that below).*

- In TXN's view, the first markets to see falling demand were industrial and personal electronics – thus those should be the first to see easy comps and bottoming demand followed by growth.

- Autos were weak during Covid and was the last market to falter.

- Inventory corrections in the channel are likely to end this year just like shortages had to correct in late 2021 and 2022.

- TXN had a good assessment of the situation on the 4Q23 call with two points:

  *"We see good opportunities in all of our markets, but we place additional strategic emphasis on industrial and automotive. **Our industrial and automotive customers are increasingly turning to analog and embedded technologies to make their end products more reliable, more affordable, and lower in power. These trends have resulted and will continue to result in growing chip content per application**, which will drive faster growth, compared to our other markets."*

  *"I think in some markets **we've seen customers that have told us that they were planning and have built their capacity and their inventories to grow at 25% in the coming year and they showed up and their plans changed and they're only going to grow 10%, right? So they told us they won't be ordering product for some time as they, you know, equalize those numbers. They're still going to have healthy growth**"*

TXN Is Building New Plants – Hurting Cash Flow Upfront

TXN is working to become more vertically integrated and is building 300mm wafer plants. These reduce the cost per chip by 40% as more chips are created in the same process on a larger wafer vs. a 200mm wafer. The Chips Act that was passed last year also incentivizes the construction of US plants. As a result, TXN has ramped its capital spending up from $3.5 billion per year to $5 billion per year and plans to be at $5 billion through 2026. There are several points to keep in mind here:

	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
Depreciation	$322	$303	$285	$265	$249	$249	$227
Capital Spend	$1,148	$1,495	$1,446	$982	$967	$790	$597
Revenues	$4,077	$4,532	$4,531	$4,379	$4,670	$5,241	$5,212

- The capital spending for new plants and equipment does not result in depreciation until the plant turns on. TXN is now reaching this stage and we can see depreciation rising.

- As plants ramp up, they initially do not open at full capacity so they are less efficient in early months. There are also production costs and few sales initially. All of this deleverages margins as depreciation along with salaries and power costs rise.

- TXN is also curtailing some production given the weak 4Q23 and 1Q24 revenue outlook. Salaries and depreciation are largely fixed costs in the short run. When this reverses, the lower cost structure should become visible.

- Capital spending (which is cash), is dwarfing the depreciation expense. We want to look at this from a cash flow perspective:

	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
Net Income	$1,371	$1,709	$1,722	$1,708	$1,662	$2,205	$2,291
CFO pre Inv.	$2,015	$2,116	$1,840	$1,691	$2,394	$2,971	$1,907
Inventory	($91)	($179)	($441)	($531)	($353)	($205)	($139)
Capital Spend	($1,148)	($1,495)	($1,446)	($982)	($967)	($790)	($597)
Dividend	($1,181)	($1,126)	($1,125)	($1,125)	($1,123)	($1,051)	($1,060)
Repurchases	($65)	($46)	($74)	($103)	($848)	($996)	($1,182)

- Cash from Operations of $2-$3 billion per quarter is not covering both the higher capital spending and the dividend at this time. Also, TXN has seen a large investment in inventory in recent quarters.

- The company has raised its dividend but has largely curtailed share repurchases at this time. There are several reasons why this picture is not as ugly as it appears at first glance:

    - TXN has $8.6 billion in cash and liquid securities it can tap to fund cash flow shortfalls.

    - TXN's debt at $11.2 billion is only 1.3x 2023's EBITDA or 1.5x 4Q23's EBITDA * 4. Thus, it could borrow more money if necessary.

    - The Chips Act will give TXN a 25% tax credit for all capital spending in the US. Thus, of the $5 billion in annual spending from 2023-26, the net will only be $3.75-$4.0 billion per year. TXN has to endure the lag time between spending the cash and collecting part of it back from the government. It expects that some of this cash will start to be seen in 4Q24. It has accruals for this cash already of $1.4 billion that will keep rising this year.

    - There are also grants that may also contribute more cash flow in the future. The timing of that is less clear, but could offset this capital spending even more.

TXN's Inventory – Look at the Complete Story

TXN's goal of higher revenue and profit margins has a great deal of focus on the inventory. Historically, TXN has carried about 145-160 days of inventory, but in recent quarters, TXN has forecast that it wanted to maintain an inventory level of as much as 200 days. We can see that with the sales turning down, even with inventory almost flat sequentially, the DSIs have jumped:

	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
DSIs	224	209	209	195	160	136	126
Fin Gds DSIs	82	73	69	63	50	41	36
Inventory	$3,999	$3,908	$3,729	$3,288	$2,757	$2,404	$2,199
Revenue	$4,077	$4,532	$4,531	$4,379	$4,670	$5,241	$5,212

However, looking at competitors – TXN does not look out of line.

	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6
Microchip DSI	167	167	169	152	139	127	125
Analog Dev. DSI	140	140	134	123	116	103	95
ON Semi DSI	165	163	159	136	127	136	139
NXP Semi DSI	133	136	134	114	98	93	88
MPWR DSI	172	202	204	212	177	173	179
MTSI DSI	195	203	180	159	151	149	129
SWKS DSI	138	186	183	168	150	155	121

Several of these competitors have been above 170 days in recent quarters and a few above 200 days. The difference between TXN and these competitors is TXN does not rely as heavily on middle-men distributors for its sales. The key to remember is distributors stock inventory too, so companies using distributors have another layer of inventory that is not on their balance sheet. Companies that rely heavily on distributors, should have lower inventory DSIs than those who do not use them as much. Here is the percentage of recent sales to distributors for these companies:

	TXN	MCHP	ADI	ON	NXPI	MPWR	MTSI	SWKS
% Distributior Sales	25%	50%	61%	60%	60%	83%	24%	89%
Normal DSI	150	120	125	125	100	170	140	150
Current DSI	224	167	140	165	133	172	195	138

- TXN and ADI both saw sales (and COGS) decline sequentially which drove up their DSIs last quarter.

- All these companies except SWKS look to be carrying more inventory than normal.

- TXN is delivering 75% of its sales directly to the customer – shouldn't it be expected to carry a higher amount of inventory? Yet its normal inventory levels are close to what many others in this group see.

- Monolithic Power Systems (MPWR) gets 83% of its sales from distributors who are stocking MPWR inventory. MPWR is still at 170 days of inventory on its books. The effective amount of MPWR inventory in the channel and on its books could easily be higher than TXN.

- ADI and MCHP get more than half their sales from distributors. Both could easily have over 200 days of inventory in the channel and on their balance sheets.

What Self-Distribution Means for Earnings

Doing more self-distribution than the competition means TXN needs to hold more inventory. Many orders are received and fulfilled very quickly. TXN also does not want to lose sales to out-of-stock situations. Gross margins for incremental sales are often 75% for TXN and its overhead costs with R&D and SG&A are largely fixed. That means that about 75% of the incremental sale falls straight to pre-tax earnings. **When quarterly sales are about $5 billion – making an incremental 1%-2% of sales because TXN has the inventory on hand is worth 3.5-7.0 cents in additional EPS and $33-$66 million in free cash flow.**

By not paying a distributor – TXN gets a higher amount of revenue per chip too. That has helped sales and gross profit. As we talked about with the capital spending, TXN is adding more 300mm wafer production that has a 40% cost advantage over 200mm units. That should add to gross margin as well.

As TXN does not mind holding 200 days of inventory with its direct distribution model, it also can run its production full-out during most slowdowns in demand. This spreads fixed costs over more output and lowers the cost of production per chip. It's this aspect where TXN is experiencing problems:

- As new plants start up – it sees full costs begin, but output has to build up to full capacity.

- With customers letting their inventory levels decline to normal levels and thus ordering less from TXN and other semiconductor companies, TXN is at the point where it is reducing production levels in 4Q and 1Q to adjust to this slowdown. That is hurting gross margin now.

- Notice that since TXN moved away from using third-party distributors – it's gross margin has been steadily increasing.

	2023	2022	2021	2020	2019	2018	2017
Revenues	$17,519	$20,028	$18,344	$14,461	$14,383	$15,784	$14,961
Gross Profit	$11,019	$13,771	$12,376	$9,269	$9,164	$10,277	$9,614
Margin	62.9%	68.8%	67.5%	64.1%	63.7%	65.1%	64.3%
% of Direct Sales	75%	70%	66%	50%	35%	35%	35%

- In 2023, the inventory correction caused sales and gross margin to decline. Even TXN is forecasting this for 1Q24 saying on the earnings call:

  *"As we have near our inventory levels, then **we have adjusted our factory loadings** accordingly. **So in third quarter, we did some of that and that had an impact on gross margins on underutilization. Fourth quarter adjustment was bigger** than third quarter. And now going into first quarter, we're taking that adjustment further. So **the first quarter adjustment on underutilization will be bigger.** But we continue to have an upward bias on inventory as we continue to build the right buffers for the right parts to be ready on the other side of the cycle."*

TXN	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
Revenues	$4,077	$4,532	$4,531	$4,379	$4,670	$5,241	$5,212
Gross Profit	$2,431	$2,815	$2,910	$2,863	$3,087	$3,617	$3,625
Margin	59.6%	62.1%	64.2%	65.4%	66.1%	69.0%	69.6%

- It looks like direct selling to customers added about 400bp to TXN's high cycle gross margin from 2017 to 2022 and the wafer change should increase that as well. Just returning to normal utilization may be worth 1000bp in gross margin recovery as the customer growth returns.

- We also want to emphasize that TXN reported that many customers are still growing orders. It is reporting that the customers thought orders would be up 25% vs 10%. Thus, this inventory situation at customers could resolve itself during 2024.

We Always Give TXN High Marks for Investing in the Business

TXN knows it operates in an economically sensitive industry that sees periods of boom and bust. However, it stays focused on the longer-term trend of rising semiconductor demand driven by chips being used in more products while the percentage of total content rises as well.

It has guided investors that in the long-run it expects to spend 20% or higher on R&D and SG&A in more normalized periods. It was repeating that in 2021 and early 2022 when the dollars spent were rising but the totals were coming in at 16%-17% of sales.

	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
R&D	$460	$471	$477	$455	$434	$431	$414
SG&A	$438	$452	$461	$474	$429	$431	$422
Stock Comp	$68	$79	$111	$104	$62	$68	$85
Revenue	$4,077	$4,532	$4,531	$4,379	$4,670	$5,241	$5,212
R&D % Sales	11.3%	10.4%	10.5%	10.4%	9.3%	8.2%	7.9%
SG&A % Sales	10.7%	10.0%	10.2%	10.8%	9.2%	8.2%	8.1%
Stk Comp % Sales	1.7%	1.7%	2.4%	2.4%	1.3%	1.3%	1.6%

Going forward, this ratio could rise in 1Q24 and even 2Q24 based on muted sales. We expect TXN to continue spending in this area regardless of short-term market conditions. We would also expect TXN's earnings recovery to come at the sales and gross profit lines – not leveraging these investment costs.

United Rentals, Inc. (URI)
Earnings Quality Update

We are maintaining our earnings quality rating of URI at 4+ (Acceptable).

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

URI's adjusted 4Q23 EPS of $11.26 beat by 35 cents. It has now lapped the Ahern deal and finished the year with an adjusted EBITDA margin of 47.8% vs. the pro forma 47.4% including some of Ahern. In the 4Q, the EBITDA margin fell to 48.5% vs. 49.4%. However, management notes that higher-cost sales of used rental equipment were the primary culprit, not Ahern. Used equipment margins were 55.3% vs. 61.6%. For starting with an acquired business with a 33% margin and adding it to a 45% margin business – URI management noted without the negative impact of lower margin used equipment sales, the EBITDA margin would only be 20bp lower. We would call that a successful integration and many of the planned synergies are already being achieved.

- Stock compensation was down $10 million y/y adding 11 cents to EPS. That will likely be a headwind next year.

- As a positive, restructuring charges added back were only 4 cents out of 31 cents for the full year. URI continues to rapidly complete programs like this and see them vanish.

- Productivity is improving and has easy comps coming. This measures price increases and the amount of time equipment is on rental. URI faced delays on some projects earlier in 2023, but it sounds on the call as if URI sees this improving further:

Fleet Productivity Growth	4Q	3Q	2Q	1Q
2023	2.4%	1.5%	2.1%	5.9%
2022	5.9%	8.9%	11.3%	13.0%
2021	10.3%	13.5%	17.8%	-0.5%

  We did notice that on the call URI was calling out LNG plants as an area of future demand that is expected to pick up. Last week after the call, Joe Biden called for a halt to all LNG plant projects.

- We noted in the past that sales of used equipment picked up in 2023 helping earnings and free cash flow. The easy comps lapped in 4Q and this may not add as much in terms of growth going forward. Also, capital spending dropped as URI has seen the supply chain normalize. Guidance for 2024 calls for gross capital spending and net capital spending to be up at most by only $200 million.

	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
CFO	$1,414	$1,062	$1,289	$939	$1,251	$1,142	$1,154
Rental Eq Purchased	($636)	($1,030)	($1,251)	($797)	($980)	($1,102)	($872)
Non-Eq CapX	($89)	($88)	($106)	($73)	($72)	($59)	($68)
Sales of Rental Eq	**$438**	**$366**	**$382**	**$388**	**$409**	**$181**	**$164**
Sales non Rental assets	$14	$18	$16	$12	$9	$6	$4
Insurance Proceeds	$8	$11	$10	$9	$7	$8	$10
Free Cash Flow	$1,149	$339	$340	$478	$624	$176	$392

- URI noted that it intends to retire more debt in 2024 which remains very low in our view. With the Ahern merger largely digested, URI's results looked like a solid beat to us.

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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