BEHIND THE NUMBERS
Quality of Earnings Analysis
October 25, 2023

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# Behind the Numbers

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## Ares Capital Corp. (ARCC)
## Earnings Quality Update

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

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

### Summary

ARCC's core EPS of 59 cents for 3Q23 beat forecasts by 2 cents. What is unique is the stock is priced right at net assets per share of $18.99, which puts the yield at 10.2% - yet there is still room to grow:

- Debt-to-equity has declined as ARCC has raised $919 million in new capital YTD. ARCC's maximum leverage goal is 1.25x debt-to-equity. That ratio has declined – giving ARCC room to grow the portfolio:

| | 3Q23 | 2Q23 | 1Q23 | 4Q22 | 3Q22 |
|---|---|---|---|---|---|
| Debt/Equity | 1.03 | 1.07 | 1.09 | 1.26 | 1.24 |

- Higher rates are helping income. It has floating-rate loans while two-thirds of ARCC's financing is fixed-rate. All loans are unlikely to have reset to the current rates yet, so there is still some room to grow there:

| | 3Q23 | 2Q23 | 1Q23 | 4Q22 | 3Q22 |
|---|---|---|---|---|---|
| Weighted Avg Yield | 12.4% | 12.2% | 12.0% | 11.6% | 10.7% |

- New loans are coming in it at lower multiples of EBITDA, with more equity behind them, and it's a lender's market with banks not doing much lending. They also see many of the private equity players who finance many of these deals sitting on considerable capital to deploy. Thus, the market could start to grow again in terms of deal quantity and boost the debt-to-equity ratio and EPS.

- Spillover income, which is income already earned and needs to be paid out as dividends, still stands at $1.18 per share. That could lead to more dividend increases or special dividends and ARCC has employed both in recent quarters. With the core EPS at close to 60 cents or higher for the last four quarters and the dividend at 48 cents, there could be more pressure to boost the yield – which stands at 10.2%.

# 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 raised 2023 guidance to $16.5+ billion from $16.0+ billion in free cash flow despite several headwinds:**

- Free Cash Flow YTD is $10.4 billion vs. $8.0 billion in nine months of 2022.

- Cash from operations was up by $1.5 billion but had headwinds of $1.0 billion in lower receivable sales, $350 million of higher cash tax payments, and payables down by $1.8 billion.

- FCF adds in the cash received from the DirecTV investment. Guidance was this would come in lower y/y and it is down $758 million so far.

- AT&T paid down an extra $500 million of vendor financing in capital spending so far this year too. Vendor financing repaid is almost equal to full-year 2022 already.

- AT&T has held capital spending forecasts for the year at about flat with $24.3 billion from 2022. So, guidance would already factor in $6 billion in spending in 4Q23 vs. $5 billion in 4Q22.

**AT&T's adjusted 3Q23 EPS of $0.64 beat by 2 cents. The normal adjustments of adding back:**

- 3-cents of DirecTV amortization

- 1 cent pension actuarial adjustment gain

- The expectation is to retire preferred stock in cash, adding 3 cents back.

- The bigger adjustment was a $604 million charge (11 cents) that was added back for the next level of restructuring that largely involves retiring more legacy (copper) lines. AT&T has reached its $6 billion cost-cutting goal which will annualize soon. This cost savings should not involve selling non-core assets and is expected to generate $2 billion in savings over three years.

- Headwinds from higher taxes hit hard in 3Q23. Guidance to start the year called for 20 cents of headwind and 11 cents came this quarter.

- The loss of capitalized interest as spectrum was put into service likely cost another 1 cent.

**Debt improvement should be more evident in 2024. The goal is to reach 2.5x EBITDA in 1H25:**

- Current net debt is $130.5 billion with a 2023 EBITDA target of $43.2 billion or 3.0x.

- AT&T just raised EBITDA growth from 3% to 4%+ growth for 2023. EBITDA growth of only 1% would require $20 billion of debt repayment and 2% $18 billion by early 1H25.

- Free Cash Flow after the dividend should be $8.5 billion in 2023, rising to $13.0 billion in 2024 and 2025 before any earnings growth – just from lower capital spending.

- Every $5 billion of debt retired, adds $150 million to cash flow via lower interest expense on an annualized basis. It also adds 2 cents to EPS.

- The latest cost-cutting move should consume cash from the $600 million charge in late 2023 and into 2024 – but should start seeing higher earnings from the cost savings by late 2024 too.

- There should still be operating leverage coming in Broadband where customers are trading up to faster speeds at higher prices and incremental customers on existing

infrastructure do not add to infrastructure costs. Plus, some of the Internet funding from the government could arrive in late 2024 or 2025 to add to cash flow as well.

- We still believe this is an easy story to get behind. Every $7.2 billion of debt that is retired transfers enterprise value to the stock by $1 per share. So, $10 billion retired per year = $1.40 in return + the $1.11 dividend or a 17% total return on the $15 stock price. If the company's multiple rises from 5.5x EBITDA to 6.5x – it adds $6 to the stock price or 40%.

# The Coca-Cola Company (KO)
# Earnings Quality Update

*We are maintaining our earnings quality rating of KO of 3- (Minor Concern).*

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

## Summary

KO's 3Q23 non-GAAP EPS of $0.74 beat forecasts by 5 cents. The beat looks real – but sustainability is a question. The company boosted guidance for organic growth to 10%-11% from 8%-9%, which looks entirely due to pricing hikes ahead of FX. The FX forecast was raised from a -3% to -4% range to -4%. KO did lower its tax rate slightly from 19.3% to 19.0%. We still believe that the level of price hikes KO is taking is unsustainable, but several other items are making less of an impact on non-GAAP EPS than in the past:

- The tax rate of 18.4% vs. new guidance of 19.0% added 0.5 cents.
- The higher capital spending of late is mitigating the drop in depreciation where KO only added 0.3 cents this quarter.
- Stock compensation declining was only another 0.5 cents.
- Pension costs were a 0.5-cent headwind.
- Inventory levels have increased again to 81.3 days, up from 74.8 days a year ago. That seems too low. The cost of sugar is up, but corn, aluminum, and plastics are down. We believe pricing gains will be tough to hold and that could pressure gross margin which was up 130bp y/y – adding nearly 2.8 cents to EPS in the quarter.

**KO reported little news about its tax dispute beyond updating the liability estimate to $5.6 billion from $5.5 billion last quarter.**

We still believe thebulk of KO's growth due to some short-lived items:

- Huge pricing gains in hyperinflationary countries
- Mexico's Peso strengthening against the US Dollar of late
- Continuing to take pricing above commodity inflation along with past price hikes still having not lapped yet

**Are Latin America and EMEA Really This Strong?**

KO is raising its guidance based on strong pricing gains in these two regions that amount to about 30% of total sales:

| 3Q23 | EMEA | Lat Am | Nor Am | Asia |
|---|---|---|---|---|
| Pricing | 19% | 15% | 5% | 1% |
| Volume | 2% | 5% | 1% | 1% |
| Organic Growth | 21% | 20% | 6% | 2% |
| | | | | |
| **2Q23** | | | | |
| Pricing | 14% | 17% | 9% | 5% |
| Volume | -5% | 8% | 0% | -1% |
| Organic Growth | 9% | 25% | 0% | 4% |
| | | | | |
| **1Q23** | | | | |
| Pricing | 22% | 18% | 11% | 5% |
| Volume | 2% | 1% | -2% | -2% |
| Organic Growth | 23% | 19% | 9% | 3% |

What jumps out to us is pricing in North America and Asia – where there are not hyperinflationary currencies – the pricing is declining. Plus, KO is reporting that more customers are shopping in discount stores and trading down to private label products. Consider what James Quincey said on the 3Q call:

> *"We've seen some shift to discount channels and switching to private label brands in a few markets and categories. The intensity of this activity was largely the same across Europe compared to the previous quarter but was less pronounced in the U.S., Australia and Japan."*

Every 1% of pricing that doesn't happen in EMEA and Latin America costs KO 0.4 cents and 0.3 cents of quarterly EPS. North America and Asia are already demonstrating that pricing is heading down significantly. It was noted on the call that some of the pricing seen is still due to 2022 pricing actions that have not fully lapped yet, those seem unlikely to repeat:

> *"We delivered 11% organic revenue growth this quarter driven by positive volume, some pricing actions in the marketplace and carryover pricing coming into the base from last year."*

Normally, KO loses much of the pricing gain from hyperinflation back to FX losses. That wasn't true in 3Q23 for Latin America, which KO attributes to the Mexican Peso strengthening against the US dollar:

| FX | 3Q23 | 2Q23 | 1Q23 | 4Q22 | 3Q22 |
|---|---|---|---|---|---|
| EMEA | -12% | -9% | -13% | -16% | -16% |
| Lat. Am | 4% | -4% | -5% | -7% | -6% |

If 3Q23 had been 0% for Latin American FX – it would have cost KO 1.2 cents in EPS this quarter. The peso has already reversed and KO boosted its outlook for FX headwind for the year.

# 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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