BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

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International Business Machines Corp. (IBM)
Earnings Quality Update

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 3Q23 adjusted EPS of $2.20 beat forecasts by 7 cents. We do not consider this a quality beat as IBM had several earnings levers to pull to come up with more than 7 cents. We will point out that some recent tailwinds in earnings from warranties, advertising cuts, and falling depreciation appear to have stalled and even become small headwinds:

- Workforce rebalancing was only $34 million. That is up from last year's incredibly low figure of $13 million which followed a $2 billion accrual with the Kyndryl spinoff that IBM was tapping for two years. This charge is lumpy but is often closer to $500 million in many years and is normally a result of IBM‘s many acquisitions:

WF Rebalance	**4Q**	**3Q**	**2Q**	**1Q**
2023		$34	$117	$259
2022	$4	$13	$28	$5

- The rebalancing charge began to normalize in 2023, and in 3Q, IBM made a $4.6 billion acquisition of Apptio. We would have expected it to rise much higher in 3Q. An additional $40-$50 million would have cost IBM 4-5 cents in adjusted EPS.

- Bad debt expense was a $9 million credit vs $11 million charge which added 2 cents to EPS.

- Guidance again was for a mid-high teens tax rate. It came in at 11.7% vs. guidance that likely had analysts expecting 15%-18%. This added 8 cents vs. a 15% tax rate and 16 cents vs. an 18% tax rate.

- Depreciation expense did not look like it was as big of a tailwind as 1Q and 2Q. IBM changed depreciable lives and predicted that would add 6 cents to quarterly EPS in 2023. It fell in 3Q by $65 million which is 6 cents compared to 8 cents in 2Q and 10 cents in 1Q. The 3Q came in where we expected and this accounting change will anniversary in 4Q.

- Advertising actually rose $6 million y/y for a small EPS headwind. This has been a driver of EPS recently with the prior three quarters showing lower advertising of $23 million, $22 million, and $32 million. This could become a bigger headwind going forward.

- Interest income was likely expected to rise and it did from $53 million to $156 million, adding 10 cents to EPS.

- We did not see an issue with standard warranty accruals which were basically flat at $18 million vs. $19 million. Extended warranties had helped EPS with a big cut earlier in 2023 of $64 million. That cut was partially wiped out with 3Q which saw the accrual hit $35 million vs. $19 million – for just over 1 cent in EPS headwind.

- R&D still looks light as IBM has become more of a software company. We compare R&D to revenue from software, consulting, and infrastructure – excluding financing and other. R&D came in at 11.62% of operating company sales in both 3Q23 and 3Q22. Yet, IBM has noted that employees are costing 8%-10% more due to inflation. We would expect spending here to increase faster than sales given the transformation in business. Even 25-50bp would be a 3.5 to 7.0-cent headwind. We know IBM is buying some of its R&D through acquisitions and then not counting the cost of goodwill or the amortization of other intangibles. But if wage growth is still an issue, we doubt this should be flat. And it's not as though revenues are on a tear, with 4.6% growth including acquisitions to argue that operating leverage is working here.

- SG&A costs excluding advertising, stock compensation, bad debt expense, workforce rebalancing along with acquisition costs and amortization came in a full 100bp lower as a percentage of sales. We'll give IBM some credit here as they have focused on this area to reduce costs. It still seems like there should be some wage inflation impacting here too. For the consulting unit, IBM touts price hikes were partially offset by wage inflation in the 10-Q.

- We will also point out the Financing segment which is getting smaller in terms of assets but reported a $35 million rise in gross profit on only a $12 million rise in revenues. IBM is pointing to lower bad debt reserves and lower SG&A here. We can envision older deals at lower interest rates repaying and new ones having higher rates helping, but some of these leases and financings last for years. We probably have much of this quantified with the $20 million positive swing in bad debt expense above. But this unit appears to have helped EPS too in the quarter and should be watched. In 1Q23, IBM said higher interest rates were hurting this unit. In 2Q23, it reported a $39 million rise in gross profit on a $39 million increase in revenues. Yet interest rates were still rising. $10 million is 1 cent in EPS, so we don't want to overstate this situation, but the recent profit growth does not seem sustainable.

Philip Morris (PM)
Earnings Quality Update

We are maintaining our earning quality rating of 4- (Acceptable)

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

Summary

PM's adjusted EPS of $1.67 beat by 6 cents in 3Q23. Highlighting one of our bigger risk items, PM boosted its FX headwind forecast to 53 cents per share for 2023 up from 33 cents after 2Q.

- The FX hits are increasing largely with Russia and Argentina.

- PM is actually boosting its volume forecast despite the industry predicting lower volume trends, driven by higher heated tobacco units.

Forecast	**3Q23**	**2Q23**	**1Q23**
Industry Vol	-1.5% to -2.0%	-0.5% to -1.5%	-1% to -2%
PM Vol	1.0% to 1.5%	+ 1%	0% to -1%
PM FX impact	-$0.53	-$0.33	-$0.30

- The tax rate was slightly ahead of the forecast for a 2-cent headwind.

- Bad debt expense rose $15 million on a slight decline in receivables for a 1-cent headwind.

- PM noted that it is boosting its investment behind its Swedish Match products and its roll-out of ILUMA in the US where is upscaling its roll-out plans. Those are headwinds early on.

- We consider the 6-cent beat solid. The one area we believe may not be a sustainable tailwind is warranties related to the heated tobacco devices. On a y/y basis, this has been steadily declining. It's been immaterial, but if the roll-out is accelerating, we would expect to see warranty expenses increase.

- There also is no EPS growth from share repurchases this year as PM focuses on reducing debt.

- We continue to see only minor charges on Russian assets. PM still has $2.4 billion in assets there including working capital. It also has a $351 million equity investment in a Russian distributor. For 2023, dividends received are $57 million so far vs $9 million in 2022 through 3Q. Under equity investing, income can boost the value of the investment, and losses and dividends reduce the value – so that is an improvement.

- In late October, PM filed its application with the FDA to sell heated tobacco in the US with its ILUMA technology. The ILUMA uses a different technology vs. the patent issues with the prior product that Altria and Philip Morris were rolling out. PM has already had ILUMA introduced in 27 foreign markets. The goal is to start rolling out heated tobacco in the US in 2Q24. PM is likely to have this market to itself early on.

- In 1Q and 2Q, PM was guiding to inflationary pressures squeezing margins. It now sees underlying costs coming down and fewer supply chain disruptions. That could provide more tailwind going forward. Supply chain issues also made it more difficult to fully fill ILUMA demand in the 1H23. That seems to be correcting.

Warner Bros. Discovery, Inc. (WBD)
Earnings Quality Update

We are holding our earnings quality rating of WBD at 4+ (Acceptable).

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

Summary

WBD reduced guidance for 2023 Adjusted EBITDA from $11-$11.5 billion to $10.5-$11.0 billion after 3Q results. This was largely due to two items:

- The various strikes between studios and their writers and actors.

- Advertising on networks not improving in recent quarters.

The writer strike has been resolved and now there is a deal for the actors. Longer strikes hurt revenues because projects for new content are delayed and there is less new content to show. That in turn also hurts all revenues including advertising. Both situations hurt EBITDA. However, lower content spending helps free cash flow in the short run. That should reverse in 4Q and 1Q, with a lagging impact on revenues.

Guidance was reduced by $0.5 billion because advertising revenues have not started to turn around thus far in 4Q. We have pointed to this as the wild card for WBD results and it may be bottoming out at this point.

There remain several positives in WBD results in our view:

- It raised forecasts for Free Cash Flow again from $4.5-$5.0 billion to $5.3 billion, after reaching $2.06 billion in 3Q and implying $2.45 billion for 4Q:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
Free Cash Flow	$2,059	$1,722	($930)	$2,412	($192)	$789

  - Remember that 1Q and 3Q are when the interest payments on the bonds are paid, so this has been a sizeable positive change already.

  - WBD's cost-cutting and synergy plans now call for $5+ billion of improvement. Those items have already been identified with many already implemented. The run rate should be $4 billion by the end of 2023.

  - That cost-cutting was expected to cost about $1.0 billion in cash to achieve. In getting to $5+ billion, the cash cost forecast was raised to $1.2 billion and then $1.5 billion. Those cash costs were a drain on free cash flow in recent quarters and should not recur at levels like that. We know there were cash costs of $400 million in 1Q23 and WBD indicated that 2024 free cash flow will not have the headwind of about $1 billion in cash restructuring costs that 2023 faced.

  - Plus, the run rate on synergies is expected to be $4 billion by the end of 2023. Some of that $4 billion will still annualize to help 2024 free cash flow. Some of the remaining $1 billion in synergies will also start to flow through.

  - Some of that higher free cash flow is going to be spent on expanding the streaming roll-outs in foreign markets and more on content growth that the recent strikes prevented. But coupled with the $1 billion in cash restructuring costs going away – WBD should be in good shape to fund its future growth plans and still see rising free cash flow.

  - Debt retirement has been $12 billion since the deal closed – that also cuts interest expense which helps FCF.

- The debt goal remains to be comfortably below 4.0x EBITDA to end 2023. After 3Q, this ratio was 4.15x ($42.9 billion in net debt over $10.33 billion of TTM EBITDA). More debt has been retired in 4Q already and guidance points to Free Cash Flow for 4Q of $2.45 billion. If debt declines $2 billion by either being repaid or having more cash on hand, and EBITDA is $10.5-$11.0 billion – the ratio will be 3.7-3.9x. Keep in mind, WBD does sell receivables and used that cash to retire debt last year. The cost of that program declined y/y in 3Q from $93 million to $36 million. This looks like a cost that could increase via higher interest rates and could need to be offset by raising less cash with this method.

- The advertising may improve with the strikes ending and new content coming in 4Q and 2024. It is down $984 million YTD at this point:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
Advertising	$1,709	$2,448	$2,237	$2,226	$1,944	$2,802

  - Keep in mind that 2Q23 did not have NCAA final four games like 2Q22 – that is some of this YTD decline.
  - The strikes had impacts on 2Q23-4Q23 – but some of that should bounce back.

- Streaming DTC continues to look better to us. The market didn't like the small drop in subscribers sequentially as WBD boosted prices and merged Discovery content with MAX leading to some attrition of customers who subscribed to both services separately. Subscriber figures fell from 95.8 million to 95.1 million sequentially. ARPU rose slightly and EBITDA continues to be positive several quarters in advance of plan:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
MAX EBITDA	$111	($3)	$50	($217)	($634)	($558)

  - Content quantity is expected to increase for DTC.
  - MAX launches in Latin America in 1Q24.
  - Numerous European countries will launch in the spring of 2024
  - The Olympics will be on Max in the Summer of 2024
  - Verizon is talking about a deal that would bundle MAX with other offerings and could boost subscribers.

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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