BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

Companies in this Issue

The Clorox Company (CLX)	p. 1
Colgate-Palmolive Company (CL)	p. 4
Church & Dwight Co. Inc. (CHD)	p. 7
Dentsply Sirona Inc. (XRAY)	p.10
Mondelez International, Inc. (MDLZ)	p.16
Otis Worldwide Corporation (OTIS)	p.19
Texas Instruments Incorporated (TXN)	p.22

The Clorox Company (CLX)
Earnings Quality Update

We are maintaining our earnings quality rating of CLX at 4- (Acceptable)

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

Summary

CLX's non-GAAP EPS of $0.93 was 15 cps ahead of consensus expectations. The company noted that sales performance in Health and Wellness was ahead of its expectations while its other segments lagged partly due to continued supply chain problems. The company reiterated

its guidance for the fiscal year ended 6/23 despite a 17 cps increase in its forecast for FX headwinds.

- Gross margin fell to 36.0% from 37.1% last year. This included a negative 90 bps impact from voluntary recall costs which the company did not add back to non-GAAP results. CLX continues to expect 200 bps in improvement in gross margin for FY 2023 with improvement starting in the second quarter.

- CLX added back $0.13 per share in costs associated with its ERP upgrade and another 12 cps for the first quarter of its cost reduction program. While the introduction of charges reduces the earnings quality in our view, the fact that the company does not have a history of huge. ongoing charges cause us to refrain from reducing our rating to a 3 for now. The company left its forecast for the size of charges under the new plan at $75-$100 million through 2024.

- Advertising expense fell again to 9.3% of sales from 10.1% a year ago. However, the company is sticking with its outlook for advertising to be 10% of sales for FY 2023. This is on par with pre-Covid figures. However, it implies that advertising's tailwind to margins will turn into a headwind next quarter as advertising spend was only 8.5% of sales in the 3/22 quarter.

While not an earnings quality matter, we see the biggest near-term risk to the company is how rapidly its volumes are eroding in the wake of its aggressive price increases. The following table shows the breakout of the growth components by segment for the last seven quarters:

Total Company	9/30/2022	6/30/2022	03/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Organic Volume	-15.0%	-9.0%	2.0%	-10.0%	-2.0%	-8.0%	-5.0%
Price/Mix/Other	13.0%	10.0%	0.0%	2.0%	-3.0%	-2.0%	4.0%
Organic Sales Growth	-2.0%	1.0%	2.0%	-8.0%	-5.0%	-10.0%	-1.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%	1.0%
FX	-2.0%	-1.0%	0.0%	0.0%	-1.0%	0.0%	0.0%
Reported Sales Growth	-4.0%	0.0%	2.0%	-8.0%	-6.0%	-9.0%	0.0%

Health and Wellness	9/30/2022	6/30/2022	03/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Organic Volume	-21.0%	-18.0%	1.0%	-18.0%	-1.0%	-12.0%	-11.0%
Price/Mix/Other	17.0%	13.0%	-4.0%	-3.0%	-7.0%	-5.0%	3.0%
Organic Sales Growth	-4.0%	-5.0%	-3.0%	-21.0%	-8.0%	-17.0%	-8.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Reported Sales Growth	-4.0%	-5.0%	-3.0%	-21.0%	-8.0%	-17.0%	-8.0%

Household	9/30/2022	6/30/2022	03/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Organic Volume	-14.0%	-4.0%	2.0%	-2.0%	-8.0%	-3.0%	4.0%
Price/Mix/Other	10.0%	8.0%	4.0%	5.0%	-4.0%	-5.0%	2.0%
Organic Sales Growth	-4.0%	4.0%	6.0%	3.0%	-12.0%	-8.0%	6.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Reported Sales Growth	-4.0%	4.0%	6.0%	3.0%	-12.0%	-8.0%	6.0%

Lifestyle	9/30/2022	6/30/2022	03/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Organic Volume	-10.0%	-3.0%	6.0%	1.0%	5.0%	-1.0%	-1.0%
Price/Mix/Other	7.0%	4.0%	-2.0%	1.0%	-1.0%	-2.0%	1.0%
Organic Sales Growth	-3.0%	1.0%	4.0%	2.0%	4.0%	-3.0%	0.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Reported Sales Growth	-3.0%	1.0%	4.0%	2.0%	4.0%	-3.0%	0.0%

International	9/30/2022	6/30/2022	03/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Organic Volume	-4.0%	-1.0%	2.0%	-5.0%	-1.0%	-8.0%	-3.0%
Price/Mix/Other	12.0%	13.0%	4.0%	8.0%	4.0%	7.0%	7.0%
Organic Sales Growth	8.0%	12.0%	6.0%	3.0%	3.0%	-1.0%	4.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	7.0%	7.0%
FX	-9.0%	-8.0%	-5.0%	-3.0%	-2.0%	-1.0%	-2.0%
Reported Sales Growth	-1.0%	4.0%	1.3%	0.0%	1.0%	5.0%	9.0%

The prices increases and the volume declines are materially larger than similar figures posted by peers. On the call, some analysts indicated they saw signs of the company losing market share in the quarter, but management was adamant that was not the case. The company is implementing further increases in the current quarter as well. Given the volume declines seen in the September quarter, we are concerned about what the December quarter organic numbers will show.

Colgate-Palmolive Company (CL)
Earnings Quality Update

We are maintaining our earnings quality rating of CL at 3- (Minor Concern)

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

Summary

CL's non-GAAP EPS for 3Q22 of $0.74 came in a penny ahead of estimates. Once again, multiple one-time benefits make us consider this a low-quality beat.

What was weak

- Other Expense (Income) after adjustments rose to $5 million of income versus $18 million in expense adding 2.4 cps to earnings in the period. The 10-Q indicates that the largest source of the improvement was due to a VAT refund in Latin America in Q3 22.

- Advertising declined on an absolute basis and fell 50 bps as a percentage of sales, adding 2 cps to earnings growth. On the call, management attributed this in part due to supply chain issues at Hill's that hampered shipments and weaker sales om Europe which led to delays in the advertising spend. In the second-quarter call, the company stated that it expected advertising to increase in the second half and remain relatively flat as a percentage of sales. This makes us believe that the absolute decline and associated boost to EPS was unexpected. If the company does not compensate with much higher advertising in the fourth quarter, we will consider that a significant red flag.

- The allowance for bad debts fell to 4.5% of gross receivables. The reserve percentage has been declining since the buildup of reserves during Covid but is now below the more normal pre-pandemic rate of over 5%. We estimate it would take about a penny per share in expenses to rebuild the reserve percentage to the pre-pandemic level and could be a larger headwind if a slowing economy forces the reserves to be built higher.

- Inventory DSIs rose to 100 days from 86 in the year-ago period and were significantly higher than the mid-to-high 70s range seen before the pre-pandemic. This may be beneficial in the short run if it helps the company in fulfilling orders. It may also benefit from selling older, lower-cost inventories at higher prices. However, this needs to be monitored going forward for signs of overbuilding. Some commodities are already coming down in price which may make future price increases more difficult to push through. Looking forward, FIFO companies that build excess inventories at today's higher costs may see margin pressure when price increases falter. CL uses FIFO for 75% of its inventories

- 2022 Global Productivity Initiative charges were only $2 million. While it did not change its estimate of the ultimate cost of the program from its previous $200-$240 million forecast, it does now expect the program to run through mid-2024 from its previous estimated completion time of mid-2023.

Things to Watch

- We have warned in the past that a disproportionate share of the company's growth is coming from premium pet care products in the Hill's pet nutrition segment. Volume growth had been running in the mid-teens rate despite price increases of similar amounts. However, the 9/22 quarter saw volumes fall by 3.5% on only 7% price increases. The company said that the lower-than-expected sales were a result of supply chain problems. This should be closely watched in the fourth quarter for further signs of weakness.

- Likewise, Latin America has been a key source of growth, with volume tracking fairly steady despite pricing boosting growth in the 7-12% range. However, pricing jumped by 20% in the third quarter resulting in an 8.5% drop in volumes. Meanwhile, FX returned to a drain on reported sales growth of 4.5%. All of this makes us believe Latin America could be a source of disappointment in upcoming quarters.

- The erosion from foreign currency translation also worsened in Asia Pacific (-8%) and Africa/Eurasia (-9%). As with Latin America, the company compensated for the weaker FX rates by increasing prices by 26% in Africa/Eurasia. This is resulting in overstated organic growth rates which remove the negative impact of FX while maintaining the benefit of the unusually high price increases. To put this in perspective, if we assume

pricing increased by 15% in Latin America instead of 20%, the company’s total organic growth rate falls to 5.9% from the reported 7.0%. Assuming Africa/Eurasia pricing increased 20% instead of 26 further reduced total organic growth to 5.6%.

Church & Dwight Co. Inc. (CHD)
Earnings Quality Update

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

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

Summary

CHD reported non-GAAP EPS of $0.76 in 3Q22 which was 11 cps above consensus. This was largely due to higher-than-expected revenue growth (+0.4% vs. the expected -1%) and lower marketing spending.

About 90% of the company's sales are benefitting from the mix into value home and personal care categories while the 10% consisting of its more discretionary Waterpik, Flawless hair removal products, and gummy vitamins are seeing lower sales and trading down to lower price points. The latter group also produces higher margins which is causing pressure on margins from the shift in mix. The above factor led the company to maintain its sales outlook for the fourth quarter but reduce its EPS outlook based on the gross margin contraction from the negative mix shift.

We saw no call for changing our earnings quality rating. The buildup in inventories and likely increase in marketing spending is our biggest near-term concern while its acquisition strategy and possible intangible writedowns remain bigger picture risks.

- Inventory continued to increase as DSI rose 81. A more normal third-quarter pre-Covid level would be in the mid-60s. The increase is being driven by lower-than-expected sales of premium Waterpik products, Flawless, and vitamin products. CHD has reduced production orders and expects inventories to work down over the next year. It also admitted it took reserves against inventories in the second and third quarters. Regardless, the elevated inventory increases the risk of markdowns in the next couple of quarters.

- The company announced in August it is acquiring Hero Cosmetics, for $565 million. Hero makes acne treatment products. We addressed in our earnings quality comparison of the consumer products companies in August that while we see CHD's earnings quality versus the other consumer products companies as relatively solid, its growth through acquisition

adds an element of risk not faced by the others. The company's disclosure of the performance of its acquisitions is sparse so it is difficult to tell how quickly growth from rolling newly annualized acquisitions into core results is helping drive core growth figures. However, we have not seen signs of deteriorating returns that accompany growth through acquisition strategies gone bad.

- The company noted in the call that the second and third quarters benefitted from a reduction in accruals for incentive-based compensation although it did not quantify. Below is the accrued wages and related benefits account which is where the accrual most likely resides.

	9/30/2022	6/30/2022	3/31/2022	12/31/2021
Accrued Wages and Related Benefit Costs	$52.50	$56.90	$46.00	$87.70

	9/30/2021	6/30/2021	3/31/2021	12/31/2020
Accrued Wages and Related Benefit Costs	$56.30	$53.90	$42.90	$124.20

It is difficult to gauge exactly how much the accrual decline in the third quarter was a result of the incentive comp reduction. If the entire sequential decline in the third quarter was due to the cut it would have added only about a penny per share to EPS. Regardless, if the company begins to hit its performance targets again (based on sales, gross profits, EPS and cash) then an increase in the accruals will be a headwind next year as the company expects.

- Lower than expected marketing costs accounted for a large part of the beat in the third quarter, just as they did in the second.

	9/30/2022	6/30/2022	3/31/2022	12/31/2021
Adjusted Marketing Expenses	$141	$103	$102	$201
% of Sales	10.7%	7.8%	7.9%	14.7%

	9/30/2021	6/30/2021	3/31/2021	12/31/2020
Adjusted Marketing Expenses	$161	$117	$99	$202
% of Sales	12.3%	9.2%	8.0%	15.6%

The company called for "higher" marketing spending in 3Q22 after the second quarter. Spending did increase sequentially, but management cited the timing of advertising

spending as contributing to the third-quarter earnings beat although it is unclear how much. Marketing spending has been depressed due to lower fill rates and management expects advertising spending to increase to 13% of sales in Q422. It is expected to be 10% for the full year and build from there in 2023 which will be a headwind for margins next year.

- The lagging performance of the Flawless products raises the likelihood of another writedown in the value of the related intangibles at the annual review. The carrying value of the asset is $465 million. The bigger picture concern of a Flawless writedown is that a sustained underperformance of a recent acquisition calls into question the success of the company's acquisition program which is a key component of its growth.

Dentsply Sirona Inc. (XRAY)
Earnings Quality Update

We are maintaining our earnings quality rating of XRAY at 2- (Weak).

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

Summary

XRAY released its restated results for several periods of results as well as 3Q22 adjusted EPS of $0.41 which missed by 17 cents. 3Q22 EPS looks more suspect considering:

- Inventory reserves dropped $2 million and added 0.7 cents
- Bad debt reserves dropped $3 million and added 1.0 cents
- Stock compensation dropped $8 million and added 2.7 cents
- We could argue that R&D fell $4 million (it had been running $45 million/quarter and came in at $41 million) and added 1.3 cents
- XRAY saw $6 million in headwind from discrete tax items costing it 2.8-cents

New management also cut forecasts for 4Q, reported huge impairments, and announced its goal of bringing XRAY back to a 20% adjusted operating margin. This all sounds very familiar.

Guidance	3Q22	1Q22	4Q21
Sales	$3.85-$3.88B	$4.1-$4.2B	$4.3-$4.4B
Organic Growth	-2%	2-3%	4-5%
Operating Margin	>15%	>17%	>21%
Adj. EPS	$1.90-2.00	$2.35-2.55	$3.05-3.25

What to Watch

- This Company has had literally no sales growth in 9 years. They can argue FX headwinds this year, but in 2014 before the merger – Dentsply and Sirona did $4 billion in sales and guidance is now for $3.9 billion in 2022. **(See Below)**

- New management is calling for the same goals as the prior two management teams. Primarily, they want a 20% margin. There are periods when XRAY hits this target for a year or two, but then it cannot sustain sales (recession curbs spending) and XRAY cannot leverage fixed costs or some costs rebound (metals, plastics, chips) and the margin drops back to 15%. XRAY's profitability was higher before merging with Sirona and finding all the magical synergies. We wonder if investors should see this as more of a cyclical and pay a low P/E when earnings are higher. **(See Below)**

- Are inventories getting too high to maintain gross margins? This could hurt sales too. We know in 2017 and 2018, XRAY was stuffing the channel and led to cratering margins in 2018. DSIs are at those levels again:

DSIs	4Q	3Q	2Q	1Q
2022		134	129	120
2021	100	109	112	110
2020	91	115	176	143
2019	109	133	130	139
2018	102	136	124	144
2017	114	127	121	126

- We see that both distributors Henry Schein (HSIC) and Patterson Companies (PDCO) have higher inventory levels too – that can lead to less ordering. **(See Below)**

- The restatements found no intentional wrongdoing by employees or management but concluded errors were made via lack of supervision, not following set policies, and lack of disclosure. The channel stuffing issues that helped reach bonus targets were not considered authorized or planned. **(See Below)**

- Restatements overall were relatively minor and impacted 2019-21. There was a greater focus on cost allocation than revenue changes and the result was marking 2021 EPS

down 4 cents, boosting 2020 by 5 cents, and cutting 2019 by 3 cents. We did notice that the gimmick used by XRAY in 4Q21 whereby it reallocated past SG&A spending to 4Q21 R&D so it could claim to hit R&D targets without spending any additional money and make earnings forecasts that were restated for multiple quarters. **(See Below).**

- Huge Write-Downs continue here. The new CFO said on the 3Q22 earnings call that his goal is to return to doing tuck-in acquisitions. We look at XRAY's acquisition history as far from perfect with another $1.3 billion in write-offs in the quarter. This was based on weaker sales growth and higher discount rate as interest rates increase. We have to wonder how these assets survived 2017-18 when sales and margins were falling and the 10-year bond yield doubled – but here is the history of write-offs:

Writeoffs	YTD22	2021	2020	2019	2018	2017
Goodwill	$1,187	$0	$157	$0	$1,086	$1,651
Impairments	94	0	39	9	179	347

- Keep watching R&D here. The goal is to be at 4% of sales and the company is cheering because with sales down, R&D is running 4.3%-4.6%. However, they came into the year forecasting $4.3-$4.4 billion in sales, which should mean they budgeted about $180 million. They were on pace for that until 3Q, which came in at $41 million down from $45 million in both 2Q and 1Q. Also, if we adjust for just FX back into sales, their ratio of spending this year has been 3.9%-4.1%.

- Several former tailwinds may not be helping EPS going forward nearly as much. We have discussed these in the past as areas where XRAY picks up a couple of cents in EPS nearly every quarter. It took credits of $5 million in 2020 and $10 million in 2021 on taxes by favorably changing its tax valuation allowance. So far in 2022, it's a -$7 million:

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Inv. Reserve	$77	$79	$86	$86	$89	$93	$95	$117
Bad Debt	$9	$12	$11	$13	$14	$14	$18	$18
Depreciation	$31	$30	$29	$30	$30	$32	$32	$38

New Management Goals Sound the Same

This is now the third management team to announce it plans to boost XRAY's adjusted operating margins above 20%. We think a bit of history is in order. Here are the adjusted operating margins from 2015-2022:

	YTD22	YTD21	2021	2020	2019	2018	2017	2016	2015
Adj. Op. Margin	17.1%	19.9%	20.3%	16.1%	18.4%	15.5%	20.0%	21.8%	21.6%

- Before merging with Sirona – Dentsply had an operating margin of 20% in 2015 and Sirona was 25%. Both were cutting R&D, but the proforma deal had the margin at 21.6%. Management pointed to $125 million in synergies that would add 330bp to margin.

- Two years later, the executives who made the deal were gone and margins were falling, despite all the synergies coming. XRAY was barely holding 20% margins and were stuffing the channel as inventories at Henry Schein and Patterson were growing by 4-9 days in late 2017 and into 2018. Plus, XRAY's own inventory rose by over 20 days in 2017 and another 10+ days in 2018 as it sought to boost gross margin by leveraging fixed costs over more output. That all blew up and sales collapsed in late 2018.

- The second management focused on more restructuring which started in late 2017 to find additional synergies and cost savings by cutting 6% of the workforce and simplifying the organization. The goal was a 22% adjusted operating margin by 2022 after hitting 20% in 2020. 2022 is now expected to be 15%.

- To be fair, 2020 started with Covid and closed dental offices so maybe they deserve a pass for 2020's 16% margin. But then we know late 2020 and early 2021 had a rocket-ship of reopening offices and dentists were working overtime – so maybe the 20% margin in 2021 is a bit overdone too.

- The third team hasn't been here long – but they are at 17% YTD, and are guiding to a margin above 15% for 2022. The new plan is to reach a 20% margin by simplifying the organization and restructuring again.

- Want another fun stat? Before the Dentsply and Sirona merger – these firms were doing $3.96 billion in sales in 2014 and $3.74 billion in 2015. Sales have been a few dollars +/-

around $4 billion ever since and guidance is for $3.85-$3.88 billion in 2022. There has been no top-line growth here (even from just inflation) in the last nine years. So margin is the wild card. The interesting part now is the 20% margin goal would have a company that is less profitable than 2014-16 levels.

- Why does this happen? A big reason we see is the operating model. A large part of XRAY sales goes to distributors like Patterson Companies and Henry Schein. Those customers may buy more from XRAY to get better pricing, but then they buy less in the future as they work down the higher inventories. Also, dental demand by the end consumer is influenced by the state of the economy. When people are broke (gas and food prices are high), they go to the dentist less, they don't buy aligners, and they skip X-rays during visits. Sales growth turns negative and now XRAY cannot leverage fixed costs and margins fall. We already know that their inventories look high now.
    - HSIC's Inventory DSI have been higher and they are seeing inventory levels fall in dollar terms and DSIs now:

HSIC	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Inventory	$1,818	$1,823	$1,871	$1,861	$1,784	$1,688	$1,626
DSI	77	80	77	72	72	74	73

    - PDCO's Inventory and DSIs are also showing elevated levels:

PDCO	Jul22	Apr22	Jan22	Oct21	Jul21	Apr21	Jan21
Inventory	$875	$786	$869	$830	$770	$737	$838
DSI	66	55	63	57	56	53	62

Restatements Were Minor Overall

Much of the overhang for XRAY stock this year has been management's exit amid accounting scrutiny and an inability to file audited financial statements. Earlier this month, XRAY was able to file restated reports for 3Q21 and 4Q21. It also filed the missing 2Q22 10-Q and now 3Q22 information. Restating results is never a positive. But, the final outcome of the restatement here was fairly minor. The audit/restatement focused on two areas:

- Customers were given incentives and extended payment terms in 3Q21 and 4Q21, which helped sales by $38 million and $70 million. That led to higher inventory in dealer channels and hurt sales in 1Q22 and 2Q22. They were looking to see if pay incentive targets were met by doing this and if this was by design.

- Incorrect accounting and assumptions in determining sales return provisions, warranty reserve, and variable pay were part of the review because it appeared these figures were out of line with historical assumptions.

- The conclusions on both aspects were that errors were made in accounting for incentives and sales returns. They did not find intentional misconduct, but failure to supervise and employees not conforming with set policy as well as lack of disclosure in SEC documents.

- The conclusions were to restate parts of 2019-2021 results – this is a quick summary of the income statements. The bigger impact was moving cost items more than it was a sales issue:

Restatements	2021	2020	2019
Sales Chg.	-$20.00	-$3.00	-$7.00
Op. Income Chg.	-$14.00	$9.00	-$8.00
Net Income Chg.	-$10.00	$10.00	-$7.00
EPS Chg.	-$0.04	$0.05	-$0.03

- We complained about 4Q21 results after we warned that XRAY was hitting its earnings forecasts during 2021 by underspending in R&D despite its repeated goal to spend 4% of sales in that area. In 4Q21, XRAY magically hit the 4% figure but did so by reclassifying SG&A costs already spent earlier in the year to R&D in the 4Q. Thus, the company didn't spend any more money on research, it simply reduced prior SG&A and called it research. It was nice to see that in three years of restatements – XRAY actually reworked its reported R&D figures and SG&A figures all years to conform with a consistent policy.

Mondelez International, Inc. (MDLZ)
Earnings Quality Update

We are maintaining our earnings quality rating of MDLZ to 2- (Weak).

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

Summary

MDLZ reported adjusted EPS of $0.74 in 3Q22, which beat estimates by 5 cents. We did not see this as a clean beat:

- The company guided to the low-mid 20% range on tax rate and came in at 18.8% down 450bp. This added 3.7 cents to EPS.

- MDLZ took the largest price hike in Latin America in years of 25.8%, FX was only a 10% hit against that. That was 23% of the total company price hike for a division that is only 12% of sales. We can look at this a couple of ways:

  - If Latin America pricing was 500bp lower– it still would have doubled the FX hit and cost MDLZ 2.2 cents in EPS.

  - Or we could simply use the net pricing here due to hyperinflation FX hits and say Latin America should be viewed as adding 25.8% pricing less 10% in FX for a net 16.8% - and MDLZ adjusted EPS would be 4.4 cents lower.

- We also would highlight that pricing gains accelerated at the rest of the units as prior price hikes fully worked into the mix. From the 10-Q – *"Higher net pricing in all regions was due to the benefit of carryover pricing from 2021 as well as the effects of input cost-driven pricing actions taken during the first nine months of 2022."*

- However, many commodity prices are falling now and large retailers are pushing for price cuts. North America had a 12.6% price hike, if that was only 11.6% - it costs MDLZ 1.2 cents. Europe took 9.8% in pricing, at 8.8% that's 1.6 cents in EPS lost. The point is we are likely closer to an inflection point where accelerating price hikes may reverse. Also from the 10-Q – *"Favorable volume/mix was driven primarily by volume gains in Latin*

*America and AMEA, partially **offset by volume declines in Europe, due to disruptions caused by pricing negotiations**, and North America."*

What to Watch

- MDLZ finally rebuilt some inventory. Inventory rose $471 million y/y and $355 million sequentially in 3Q22. DSI had been 8-9 days lower than normal, and this added 3 days to the total. We still think the company is light here by at least 5 days. Cash flow is tight too. Free cash flow in 3Q22 was only $313 million impaired by receivables rising by $398 million and inventories by $379. It spent $812 million on share repurchases and dividends plus $2.6 billion on another acquisition. We also believe buying more inventory now will boost Cost of Goods Sold and pressure gross margin.

- Despite the massive price hikes, Gross margin is still declining. This is even worse because the pure price hikes vs. higher input costs was about the highest we have seen:

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Gross Margin	37.4%	37.9%	38.8%	37.2%	38.4%	40.0%	39.6%	39.2%
Op Inc from Px	$817	$532	$349	$190	$207	$130	$151	$127
Input Cost Op Inc	-$545	-$436	-$191	-$225	-$179	-$20	-$49	-$120
Net gain Op Inc	$272	$96	$158	-$35	$28	$110	$102	$7

  This area alone looks $100 million higher than many would have expected. That plus the tax rate falling would have accounted for more than the EPS beat in 3Q22.

- Leveraging SG&A is happening as MDLZ has planned. However, how much of this is due to the huge jumps in pricing also? Plus, we are seeing in their earnings discussion that advertising and promotional costs are increasing. Some of that is just returning to normal after Covid let those costs fall or grow more slowly. Adjusted SG&A is still rising in dollar terms:

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Adj SG&A %	21.3%	22.8%	21.1%	21.8%	21.2%	23.8%	21.7%	22.9%
Adj SG&A	$1,648	$1,656	$1,632	$1,670	$1,514	$1,573	$1,574	$1,401

Some of the increase in dollars is due to acquisitions and the higher advertising that MDLZ does not quantify except in the 10-K. We think investors should be looking that SG&A as a percentage of sales actually grew by 10bp with an 11.4% price hike. If the price hike was 10.4%, it would have risen by 27bp. Is this an inflection point quarter? The operating leverage has been very visible until now.

- Raised guidance looks very easy to beat for 4Q. MDLZ boosted organic revenue growth to 10%+ for the year from 8%. It would need $2.8 billion in organic growth to achieve that target and are already at $2.34 billion through 3Qs. They only need $455 million more in organic growth in 4Q22 which is 5.9% y/y growth and that compares to the last easy comp on pricing of only 2.6%.

- MDLZ is making more acquisitions and not expensing much of the cost. It's all rolling through the cash flow statement and balance sheet instead of income. Clif Bar cost $2.6 billion and MDLZ allocated $1.5 billion in indefinite-lived intangible assets and another $1.0 billion to Goodwill – that's 92% of the purchase price will not be expensed on the income state, which will see higher sales at a minimum.

  Same thing with Chipita. MDLZ paid $1.89 billion and put $1.48 billion into indefinite-lived intangible assets and Goodwill. 78% of the total price will not be expensed. With this type of accounting, it's definitely cheaper from the perspective of the income statement than building it yourself and expensing R&D, equipment, wages, new distribution assets… However, the debt figure does rise – up $2.1 billion YTD and cash is down $1.1 billion YTD.

Otis Worldwide Corporation (OTIS)
Earnings Quality Update

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

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

Summary

Adjusted EPS at OTIS was $0.80 in 3Q22, which beat by 2 cents. We would not consider it quality beat as:

- Bad Debt expense was $0 in 3Q, vs. $12 million the year before. That was worth 2 cents in adjusted EPS. Bad debt reserves are down $10 million since 2Q.

- Stock compensation was down $5 million y/y – that added 0.9 cents.

- Warranties beyond the normal service and parts policies is a small account that has been falling for some time. It had only $1 million of expense in both 3Q22 and 3Q21, but the balance is down from $20 million to $13 million YTD.

- Offsetting this was a higher tax rate – which OTIS guided to. It is still guiding to a 26.5%-26.7% tax rate, but in 2Q22 it was only 22.4% and helped OTIS beat forecasts. It expected 3Q to offset that and it came in at 28.2%.

OTIS cut guidance again. This has been a constant for 2022 earnings since the 4Q21 release. This has been a combination of China lockdowns, removing Russia, FX, inflation, and a lack of labor for other construction firms meaning has taken longer for projects to reach the stage when OTIS can do its installations. OTIS sounded positive that some of these factors are turning in their favor again:

OTIS 2022 Outlook	3Q22	2Q22	1Q22	4Q21
Adj Sales	$13.4-$13.5B	$13.6-$13.8B	$14.1-$14.3B	$14.4-$14.7B
Organic Growth	2.0-2.5%	2.0-3.0%	3.0-4.0%	2.5%-4.5%
Op. Profit	$2.1B	$2.1-$2.2B	$2.2-$2.25B	$2.24-$2.3B
Adj. EPS	$3.11-$3.15	$3.17-$3.21	$3.22-$3.27	$3.20-$3.30
Free Cash Flow	$1.5-$1.6B	$1.6B	$1.6B	$1.6B

The lower EPS forecasts are being helped by OTIS raising its guidance for share repurchases after 2Q and 3Q. But, on the call management did point to New Equipment backload growing 12% and even China was up slightly. They still have a negative China for the year. They are seeing better pricing everywhere except China so that will flow through in 2023.

What to Watch

- Working capital has had some headwinds this year, 3Q had some of the worst of it:

Working Cap Chg	3Q22	2Q22	1Q22
A/R	-$67	-$53	-$51
Inventory	-$41	-$25	-$14
Other Cur Ass	-$14	-$56	$56
A/P	$2	$171	-$36
Accr. Liabilities	-$26	$38	-$178
Contract Ass/Liab.	$9	-$144	$278

  - Receivables are up due to more billing coming later in the quarter as orders built. The peak was 92 days during Covid, OTIS is at 85 days now up from 83 in 2Q22. Turning the tide of orders is likely a larger positive than 2-days of DSO.
  - Inventory is up with inflation and efforts to support order flow.
  - Payables jumped as OTIS prepaid suppliers to lock in deals. This may still represent some cash outflow going forward.
  - Contract assets/liabilities are the result of progress payments made during projects that may not fully match with revenue recognition. The drop in new orders in China in particular skewed that in 2Q22. Also, with fewer new orders, there are more contracts near the end stage and these accounts meet at $0. If orders are picking up, this could return as a source of cash.

- The maintenance/repair/modernization story for OTIS appears to be intact. The headlines are often on new-equipment orders. However, the M/R/M market has larger sales, about triple the profit margin, and it isn't something that can be postponed. Customers who postpone modernization, often have more service calls. The OTIS story is built on this area of the company reducing costs with more digital fixing of systems without on-site visits. They aim to reach 30-50bp of margin improvement annually, and that is still happening. The modernization business is also accelerating of late:

Maint/Repair/Mod.	3Q22	2Q22	1Q22	4Q21
Organic Growth	6.2%	5.2%	5.8%	4.0%
Maint/Repair	5.4%	4.9%	3.0%	4.3%
Modernization	10.3%	6.4%	-5.9%	2.2%
Adj. Op. Margin	23.9%	23.1%	22.9%	23.0%
Margin gain y/y	50bp	50bp	30bp	50bp

- The goal to retire debt and shares is also continuing. The higher cash consumption of working capital lowered the cash balance so net debt looks slightly higher, but it's still only 2.3x adjusted EBITDA. Total debt is still coming down:

	3Q22	2Q22	1Q22	4Q21
Gross Debt	$6,562	$6,683	$6,745	$7,273
Net Debt	$5,528	$5,465	$5,510	$5,708
Shares	421.2	424.2	427.7	429.1

- FX should be a headwind again in 4Q22, then the y/y comparisons should start to ease.

Texas Instruments Incorporated (TXN) Earnings Quality Update

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

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

Summary

TXN's adjusted EPS of $2.56 beat by 14 cents and came in 5 cents over the high-end of guidance. The accounting remains very clean and high quality. TXN pointed to slowing sales for 4Q22 with revenue of $4.4-$4.8 billion and EPS of $1.83-$2.11. It did see some cancellations start from customers in 3Q too. After growing sales in 3Q in 4 of 5 end markets, TXN sees 4Q showing growth only in autos.

- The beat looks solid. The 7 cents of start-up costs should start moving to Cost of Goods in late 4Q. That will stop this cost from being its own line item as 2023 starts.

- Pension costs rose by $10 million in the quarter and stock compensation rose by $18 million. Combined those were headwinds of 2.6 cents.

- Cash flow was flat at $1.976 billion vs. $1.942 billion y/y despite $300 million of higher capital spending. There was help from receivables declining $150 million while inventory rose $205 million.

- DSO's are coming back down again which is a positive. Remember that 2Q was back-end loaded due to China orders being fulfilled late in the period. DSOs for TXN are nearly always 32-33 days and hit 38 days in 2Q22. It declined back to 36 days in 3Q.

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Accts Rec.	$2,040	$2,190	$1,795	$1,701	$1,653	$1,591	$1,584	$1,414
DSO	36	38	33	32	33	32	33	32

- Inventory is still below TXN's target and it is likely to keep producing to get back to levels where it can avoid out-of-stocks. That runs fixed costs over more output

too, but we expect inventory to consume cash flow going forward at least $800 million more.

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

- Expect depreciation to become more of a headwind as the first new plant starts up in late 4Q/early 1Q. Deprecation in 3Q22 was $249 million vs. guidance for the year of $1 billion.

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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