BEHIND THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

Companies in this Issue

DoorDash, Inc. (DASH)
Earnings Quality Update

We are maintaining our earnings quality rating of DASH of 2+ (Weak)

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

DASH reported 3Q23 results that beat forecasts for Gross Order Volume (GOV) and reported Adjusted EBITDA of $344 million which was $74 million ahead of the high end of guidance. We believe much of this outperformance can be attributed to low-balling forecasts in the first place. GOV was forecast to come in at $15.8-$16.2 billion for 3Q and $64.2-$65.2 billion for the year, or $16.0-$16.2 billion for 4Q. That guidance was below what DASH already produced in 1Q - $15.9 billion and 2Q - $16.5 billion. GOV coming in at $16.75 billion beat forecasts, but still showed a decelerating rate of growth:

DASH	3Q23	2Q23	1Q23	4Q22	3Q22
Order Growth	24%	25%	27%	27%	27%
GOV Growth	24%	26%	29%	29%	30%
Revenue Growth	27%	33%	40%	40%	33%

Adjusted EBITDA was helped significantly by some cuts in key cost items in its jump last quarter to $344 million. Guidance for Adjusted EBITDA going into the quarter was for $220-$270 million, or a midpoint of $245 million. This looked very easy to beat as DASH had $279 million in adjusted EBITDA in 2Q23:

DASH	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
Adj. EBITDA	$344	$279	$204	$117	$87	$103	$54

We question how much of the gain can be sustained given the size of the cuts to key expenses discussed below:

Selling and Marketing expenses have been declining in dollar terms sequentially

S&M was flat in 2022, but has been falling in 2023 which has been helping EBITDA:

DASH	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
Adj. S&M	$413	$429	$466	$395	$386	$388	$395
y/y chg advertising	$18	$25	$51	$1	-$65	-$51	$49
y/y chg payroll	$7	$16	$25	$34	$39	$40	$25

- A big part of this has been DASH cutting back on advertising as a percentage of sales and in dollar terms. A $65 million drop in 3Q22 followed by an $18 million increase in 3Q23 is still below 2021 levels. Given the big drop in 2022, we believe DASH may have picked up $25-$30 million here. Can this last?

- Payroll growth has also largely vanished. More employees in the tech sector are getting raises, but not at DASH. Will this last? This looks like another $20-$25 million at least.

General and Administrative costs have been seeing growth in payroll costs and growing y/y and sequentially – suddenly it dropped in 3Q23. Does this $50 million sequential and y/y drop look sustainable:

The following table shows adjusted general and administrative expenses and the year-over-year change in payroll costs for the last 7 quarters:

DASH	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
Adj. G&A Exp	$170	$211	$200	$199	$211	$172	$177
y/y chg payroll	$10	$30	$52	$63	$80	$43	$27

- The company talks about operating leverage with higher revenues over selling & marketing. We expect some of that – but huge drops in dollar terms against higher sales and no explanation looks suspicious to us. The only rationale we see is not boosting wages – which definitely does not look sustainable.

Adjusted R&D is also declining in dollar terms which does not seem sustainable.

Adjusted research and development costs for the last 7 quarters are shown below:

DASH	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
Adj. R&D	$126	$130	$129	$131	$122	$106	$88

DASH again incurred higher legal costs- which are ignored by the company's adjusted results.

We have highlighted that DASH faces significant litigation risk and legal fees and settlements are becoming a regular cost of doing business, yet the company is adding these rising expenses back to its adjusted profits. The following table shows legal costs for the last 7 quarters:

DASH	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
Litigation	$44	$49	$19	$19	$14	$15	$24

Stock compensation fell sequentially after a big increase in 2Q23 and a gap down in 1Q23:

The calculation of stock compensation as a percentage of revenue is shown below for the last 7 quarters:

DASH	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
Stock Comp	$280	$312	$230	$268	$251	$231	$130
Revenue	$2,164	$2,133	$2,035	$1,818	$1,701	$1,608	$1,456
Stk comp % Rev	12.9%	14.6%	11.3%	14.7%	14.8%	14.4%	8.9%

- We view declines in stock compensation add-backs as an improvement in earnings quality. That has improved in two quarters this year. However, guidance expects it to jump to $320-$340 for 4Q.
- More importantly, the decline in stock compensation indicates that as cash wage growth stalled, employees didn't get more stock pay either. How sustainable is this?

Conclusion

DASH beat the high end of EBITDA guidance by $74 million. To get there it added back an additional $30 million in litigation costs, had a sudden $50 million drop in G&A costs, a large decrease in advertising, and it appears that employee pay increases have stalled and R&D is flat-to-down. These boosts to EBITDA filter down to earnings. In addition, earnings benefitted from interest income rising by $31 million.

Non-GAAP EPS beat by 31 cents or about $122 million. We believe the entire beat can be attributed to the $31 million in interest income, the drops in Selling and Marketing (particularly advertising), the $50 million drop in G&A, and adding back an incremental $30 million in litigation.

Stanley Black & Decker (SWK)
Earnings Quality Update

We are raising our earnings quality rating of SWK from 3+ to 4+ (Acceptable).

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

Summary

SWK's Non-GAAP EPS of $1.05 beat by 22 cents. It raised guidance for 2023 from $0.70-$1.30 to $1.00-$1.40.

We believe it is important to note that SWK continues to add back only one-time restructuring charges to non-GAAP results (not stock compensation, not taxes, not legal costs like many others). Of the $1.02 added back in 3Q23 – only $0.36 was due to restructuring compared to $1.29 in 2Q23, and $0.86 in 1Q23. The rest in 3Q was related to a trademark impairment. The restructuring bills are getting smaller.

Also worth noting is SWK faced several headwinds to EPS and still beat handily which further reflects how the business is improving:

- Stock compensation rose to $18.4 million from $14.2 million y/y and $12.1 million sequentially – giving a headwind of 2-3 cents.

- Warranty expense rose to $46.1 million from $38.3 million – for a 4-cent headwind.

- Pension costs were up $9.0 million y/y largely due to higher interest cost – hurting results by 5 cents.

- FX contracts recognized in Cost of Sales swung from a $14.8 million gain to a loss of $0.7 million – that was an 8-cent headwind.

- Bad debt reserves look low at 5.2% vs. 8.0% to start the year. However, SWK wrote off and removed $20 million of the reserves in 2Q. About 1.2% of the decline is due to this and the rest due to a rise in receivables. Bad debt expense was actually up $1.7 million y/y.

- Watch for an uptick in tax rate in 4Q. SWK noted in the 10-Q that 3Q23 taxes benefited from an interim tax benefit that is expected to partially reverse in 4Q.

The Rate of Decay Is Improving Rapidly

SWK Vol.	9/1/23	7/1/23	4/1/23	12/31/22	10/1/22	7/2/22	4/2/22	1/1/22	10/2/21
Overall	-3%	-5%	-11%	-10%	-10%	-13%	-6%	-8%	8%
Tools/Outdoor	-3%	-6%	-13%	-12%	-12%	-16%	-6%	-8%	11%
Industrial	-4%	-1%	-2%	1%	5%	4%	-5%	-9%	-1%

- There is no doubt that there are easy comps after several negative quarters for Tools/Outdoor.

- SWK noted on the call that North American tools and hand tools were positive last quarter. There remains some destocking going on for Outdoor, but that sounds like it is over for Tools and it should be largely over for Outdoor in 4Q.

- Industrial volumes were hurt by the strikes at auto plants – which are now resolving.

On the earnings call – management noted that after seeing consumers buy tools and equipment for home projects during Covid, they are seeing end-user demand rise again and destocking may be over as 2023 finishes which should help volumes turn positive again:

> *"Across our end market, **the U.S. retail point-of-sale for our Tools and Outdoor products remained in a growth position this quarter vs. 2019 levels**."*
>
> *"Our Attachment Tool business experienced organic revenue declines, primarily as a result of customer destocking to normalize their inventory levels. The long-term fundamentals for growth remain solid in all these businesses **and we believe the temporary channel inventory destocking in Attachment Tool will be complete as we exit 2023."***
>
> *"Now turning to the Tools and Outdoor third quarter performance. Total revenue was $3.4 billion, down 5% organically versus prior year as a result of lower consumer Outdoor and*

DIY market demand. ***<u>Our Tools SPUs in aggregate were positive organically in the quarter, excluding the Russian business exit, while Outdoor, was down 23% consistent with our expectations.”</u>***

The Inventory Levels Continue to Improve

The table below shows how inventory levels have normalized after the unexpected buildup in 2022:

SWK Inv.	9/30/23	7/1/23	4/1/23	12/31/22	10/1/22	7/2/22	4/2/22	1/1/22	10/2/21
Finished Product	$3,014	$3,258	$3,472	$3,461	$3,840	$4,115	$4,023	$3,486	$2,777
Work in Progress	$274	$238	$260	$339	$357	$456	$429	$395	$350
Raw Materials	$1,690	$1,787	$1,928	$2,062	$2,150	$2,065	$1,816	$1,539	$1,007
Total Inventory	$4,978	$5,283	$5,660	$5,861	$6,347	$6,636	$6,268	$5,420	$4,134
DSI Finished	95.9	93.4	102	97.4	112.7	117.5	116.5	111.1	98.6
DSI Wrk Progress	8.7	6.8	7.6	9.5	10.5	13	12.4	12.6	12.4
DSI Raw Mat	53.8	51.2	56.7	58	63.1	59	52.6	49.1	35.7
Total DSI	**158.3**	**151.4**	**166.3**	**164.9**	**186.3**	**189.5**	**181.5**	**172.8**	**146.7**

- This has happened even while selling into a negative volume demand environment. SWK still believes it can reduce inventory by $400-$500 million in 2024 and 2025, but being down $1.7 billion since 2Q22 is quite a feat.

- There is still seasonality for sales with the Holidays and Summer being stronger, so DSIs are often higher leading into 2Q and 4Q.

- Some of this inventory reduction also involved eliminating SKUs and selling those off in a glutted market.

- The hard work may be completed here especially if there is a tailwind of flat or positive volume growth in 2024.

The Margins Are Recovering

The table below shows gross margin and SG&A as a percentage of sales for the last 9 quarters:

SWK Margin	9/1/23	7/1/23	4/1/23	12/31/22	10/1/22	7/2/22	4/2/22	1/1/22	10/2/21
Adj Gross Margin	27.60%	23.60%	23.10%	19.50%	24.70%	27.90%	31.30%	29.00%	32.30%
Ad SG&A %	19.30%	19.50%	20.50%	18.30%	18.40%	18.70%	19.80%	20.10%	20.00%

- The goal is still to return to a 35% gross margin where SWK was before Covid and the boom and crash of demand. At 35% - the company earns about $12 per share.

- SWK is hinting that 2024's EPS could be $4-$5 vs the $1-$1.40 in 2023. That will depend on volume growth improving going forward and the company is not trying to time this by quarters, but is laying out the total plan.

- The 8.3% operating margin in 3Q23 is arguably more impressive considering the following:

    - SWK curtailed production to work down inventories into negative volume growth. That means costs for wages, depreciation, marketing were spread over less volume.

    - Eliminating SKUs was also part of the plan. That normally involves discounting prices to move inventory that retailers know will not get future support from SWK. It also likely disrupts production as workers are moved and lines are re-tooled.

- Inflation for shipping costs and commodity costs also built up in inventories that have been sold into a weak market. That squeezed margins and now cheaper inventories are starting to become part of Cost of Goods Sold.

Here is some of the discussion about the operating model improving:

"We made substantial progress in improving adjusted operating margin to 9.3%, this was a sequential step up of 480 basis points and 250 basis points better than last year. ***<u>This improvement was driven by reduced sell-through of high cost inventory, supply chain</u>***

transformation savings and reduced shipping costs, which were partially offset by lower organic revenue.”

“Moving forward, we expect continued adjusted gross margin rate expansion driven by the benefits of the supply chain transformation. ***Our guidance calls for adjusted gross margin to incrementally improve again in the fourth quarter.***

Now that the high cost inventory has turn through the P&L, ***we expect to continue to deliver expanding adjusted gross margin into the first half and full year 2024*** *supported by the success of our supply chain transformation.”*

“Deflation also help in the quarter mostly from shipping coming off the balance sheet of another 100 basis points to 150 basis points. And then broader high cost inventory coming off the balance sheet of around 300 basis points.”

“I'd say for the most part 2024, we expect production to be normalized*. Obviously, as we and the rest of the Outdoor industry find the new kind of post-COVID Outdoor base, we will be mindful of the production levels in our Outdoor space. But that's kind of $2 billion-ish of $13 billion, $14 billion T&O business.*

*So I think those production schedules will be in tied to the market realities we see in Outdoor. But broadly speaking****, in this fourth quarter and as we head into 2024, Tools production has normalized.”***

WESCO International, Inc. (WCC)
Earnings Quality Update

We are maintaining our earnings quality rating of WCC at 5- (Strong) and keeping WCC on our Focus Value List

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

Summary

WCC's Adjusted EPS of $4.49 beat forecast by 62 cents. Most of that sizeable beat came from one-time tax items like in 1Q23. WCC boosted EPS guidance from $15-$16 for 2023 to $15.60-$16.10 based on the tax tailwinds:

- Reversing the valuation allowance against Brazilian deferred tax reserves was $11.9 million or 23 cents of the beat.

- Higher foreign tax credit utilization was $10.5 million, or 20 cents.

- Tax benefits from stock compensation was a net change of $4.4 millio, or 8 cents.

The beat still looks solid with that 51 cents of largely one-time items. There were some headwinds too:

- With flat volumes the volume rebate from suppliers was down, impacting Cost of Goods Sold by 50bp – which is 33 cents. Without this change – gross margin would have been flat.
- Keep in mind, as part of the inventory destocking process – WCC guided to a 40bp headwind for Gross margin in 2H23. It came in at 50bp for 3Q, which may imply some improvement for 4Q and a tailwind for EPS. That is not factored in as the guidance increase was due to the tax items.

- WCC has one fewer work day in the quarter which hurt sales by 1.6% and would deleverage fixed costs slightly. SG&A came in flat as a percentage of sales.

What to Watch:

- Inventory continues to decline from the periods of supply chain delays and then 1Q when many orders on backlog arrived near quarter-end:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Inventories	$3,541	$3,584	$3,730	$3,499	$3,490	$3,166	$2,881	$2,666	$2,570
DSIs	73.7	72.4	77.8	74.2	75.7	67.1	66.8	63.5	61.1

WCC is likely still about 8-10 days of inventory higher than where it wants to be. This helped cash flow by $11.2 million in 3Q, but 8-10 days could free up about $400 million more of cash from inventory. That would be offset by falling payables for a net amount above $100 million.

- What we always liked at WCC is the underlying markets are still growing – which makes it easier to bring inventories down. Currently, the end markets are reducing inventories too which is offsetting volume growth in other end markets and continued growth in cross-selling acquired companies. WCC just posted a volume figure of 0.2% in organic growth for 3Q23. The acquisition is another 2.4%.
    - Destocking at ESS moderated in 3Q compared to 2Q, should continue in 4Q.
    - Destocking at Broadband continues and should through 1H24
    - Backlogs remain above historical levels
- The inflection point should be near where pricing moderates more, but volumes pick up again. In 3Q, pricing was about 3% due to actions taken last year that have not fully lapped yet. That should also push inventories and COGS growth down too. As pricing fully laps and the destocking is completed, the volume growth should return. We would expect WCC to see the following in 2024:
    - Cash freed up from inventory levels in unit terms and some pricing relief.
    - Unit demand to return as customers work off their inventories.
    - As WCC's orders and deliveries normalize – it should earn more rebates from its suppliers – helping gross margin.

- Its own customers could earn larger rebates from WCC too which are booked against sales. The net impact of rebates rising overall – is a small headwind for WCC. During destocking – it should be a small tailwind to help net pricing and offset any volume weakness.

- The higher volume though should leverage costs more and help margins. Much of the cost reduction efforts are happening during this whole process of inventory reduction and lower volume growth and should be more evident as the situation normalizes.

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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