BEHIND THE NUMBERS

Quality of Earnings Analysis

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Behind the Numbers

Companies in this Issue

Air Lease Corp. (AL)
Earnings Quality Update

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

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

Summary

AL's adjusted $1.42 in 4Q22 missed by 3 cents. As a financial stock, we see this more of a book value and interest spread story and in both cases, the story remains compelling in our view with conservative accounting clouding some of that. We think AL could be sold today at a 40%-50% premium to the current stock price. The rate of new planes arriving is starting to improve and that should lead to higher revenues and help income recover as well.

- EPS was helped by the repurchase of over 3 million shares – adding 4 cents to EPS.

- EPS was hurt by SG&A rising by $5.3 million due to higher insurance premiums and increased work to transition aircraft into and out of the fleet – which precedes future revenue and was a 4.7-cent headwind to EPS. This is restarting business and expenses that have been lower than normal since 2020.

- Rental revenue had a sequential headwind by having $4 million less Covid deferred rent arrive than 3Q. That's still a positive having it come in – but $4 million less is 3.6 cents in EPS. Also, the amount of rent still recognized on a cash basis was $6.4 million in 3Q, we would estimate that it was likely $5-$6 million in 4Q, for another 5 cents of headwind.

- EPS was hurt by less capitalized interest costing AL 0.4 cents.

- A new issue of preferred stock from 2021 added to preferred dividends ahead of common earnings – this was a 0.9-cent headwind.

- If we look at revenue vs expense growth sequentially – as more new planes arrive and selling older ones can take place, rental revenue grew by $19.9 million and trading by $20.4 million. The work to do that with higher insurance rose $6.1 million, the larger fleet meant depreciation rose $10.4 million, and interest rose $12.0 million. That nets out to a positive $11.8 million as AL sees a slow return to normal full operations.

The outlook looks stronger with AL expecting $4-$5 billion in new aircraft deliveries vs. $3.6 million in 2022 and $1-2 billion in aircraft sales vs. just over $200 million in 2022.

What to Watch

AL is trading at a discount to book value of $44 vs. $52. We think there are several potential catalysts to grow the book value which include:

- The remaining Covid deferred rent payments of $148 million should still come in. This will be very high cash income as the operating expenses such as depreciation and interest expense have already been booked on this delayed revenue. The tax rate is 20% - so this represents $1.07 in potential book value.

- There is a potential settlement with insurers for nationalized Russian planes. One plane was actually returned but even AL views that as an anomaly. The remaining balance here is $771.5 million – that is as much as $5.55 in book value.

- AL's operating model is to buy new aircraft and sell them after 7-10 years. The delays in new plane arrivals coming from Boeing and Airbus have been an issue for several years. That in turn has reduced AL's sale of used planes. That is forecast to ramp up going forward. With passenger traffic rising and the need for new planes not being fully met, the value of used planes should be rising. AL was normally selling planes in excess of book value before these macro factors were in place. We would expect gains on aircraft sales to rise going forward. AL noted its 10-K, "*We expect to sell approximately $1.0 billion to $2.0 billion in aircraft for 2023 and* ***have seen robust demand in the secondary market*** *to support this aircraft sales program."*

- AL depreciates aircraft on a straight-line basis over 25 years to a residual of 15%. If they have already been taking gains on aircraft sales over the book value – then the depreciation policy may be conservative and it is punishing earnings and book value. Aircraft on the books are a gross $29.5 billion and net $24.5 billion. If these planes are worth 1%-5% more than their carrying value – it would add $2.20-$11.00 to book value. This could get recognized to book value as gains on asset sales.

- Boeing and Airbus have years of backlog and that continues to grow. They are taking orders now that may not be fulfilled for 10+ years. With the demand for planes rising, that could also make the value of new planes rise too. AL finished 2022 with 398 planes on order with the bulk of them scheduled for delivery in the next 5 years. Right now those are on the balance sheet as deposits and some progress payments, but the total value eventually is another $25.5 billion. Could they switch a 2025 delivery slot for one in 2028 and collect a 10% premium on trade? AL buys and sells aircraf, why not delivery slots?

- We think a reasonable case can be made that AL's real book value is above $60 per share and the scarcity factors pushing up asset values in the market are still going up. Plus the whole balance sheet is being financed at only 3%.

The interest spread story is also compelling here. We think the market fears about rising interest rates as a major risk are misplaced and AL remains a very simple story to understand.

- The market sees a company that is leasing planes at a fixed rate for several years – so cash flow per unit is flat. At the same time AL is borrowing money to finance the deal and interest rates are increasing – so AL's profits will get squeezed. The market is missing several points that are at the core of AL's business model.

- This is not a case of having a 25-year fixed-rate lease on an airplane while interest costs to finance it rise. The basic reason for AL to exist is its cost of funding is lower than what its customers pay. AL is a BBB credit – the yield on BBB bonds is 5.5% now. It has customers who are B credits where the yield is 8.5% now – so there is a 300bp spread to work with. On top of that, AL gets a tax shield from depreciation and interest expense.

- Inflation and rising interest rates makes leasing from AL a MORE attractive story for airlines that can finance with AL cheaper than they can buy their own aircraft. So as plane values rise, that financing spread leads more customers to push AL to own more of their planes. There are several ways this gets better:

- AL has 90% of its debt fixed. Plus, its cost of debt is fixed at 3% not 5.5% - so now it's looking a fixed rate spread for a lease of 550bp, not 300bp. Yes, debt matures and rolls over. About 12%-15% of AL's debt will roll over per year – that is still not the end of world in this case:

    - AL normally sells planes after 7-10 years and often it will sell them while they are still under lease. The lack of new plane deliveries has slowed that process, but it is starting to ramp up again. So on a per-unit deal, the fixed lease revenue and fixed cost financing match and hold the same spread while AL owns the plane.

    - It is selling into a strong market for plane values. That should lead to gains on the sale in many cases and boost profits if there is a short time with a lower spread due to timing where financing rolled before the lease expired or the plane was sold. AL has 417 aircraft and 398 on order – these assets and leases turn over too. The key to understand is duration is more closely matched than many believe.

- New leases come with escalators until the plane actually arrives. So amid rising interest rates, new planes being placed will have higher lease rates. AL will lock in the financing and instead of having say a 5% lease and 2% financing, it will be an 8% lease and 5% financing. If a customer rolls over a lease on an existing plane, that resets the spread too. Again, if they end up with a bad deal – they can sell the plane to another party, while it is under lease and the market is hot due to scarcity. AL buys new planes, but there are many others who focus on used plane acquisitions.

We would still watch the US dollar as a risk here. AL collects rent in US dollars and airlines buy fuel with US dollars. However, many foreign airlines collect passenger fares in other currencies. Thus a strong US dollar can squeeze the margins of foreign customers.

LyondellBasell Industries N.V. (LYB)
Earnings Quality Update

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

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

Summary

LYB's 4Q22 EPS of $1.29 beat by 2 cents. The beat looks solid, but this was a weak quarter overall given several plants operating below capacity as LYB guided to in 3Q. The only adjustments remain marking some inventories to Lower-of-Cost-or-Market and costs declined in 4Q, triggering a net $90 million LCM change. That is a normal item for LYB. Also, it still plans to close its refinery operation and as LYB has guided to – that resulted in retirement costs continuing that should be the case during 2023.

We will point out one area of EPS benefit related to the refinery exit charges. Depreciation and amortization declined y/y by $43 million or 10 cents in EPS. Amortization was expected to decline this year modestly. We believe much of the decline is related to accelerated depreciation as part of the refinery closing costs and a large impairment for the refinery in 4Q21. That should result in a permanently lower depreciation level for LYB. The exit costs were $95 million in 4Q22 and added 21 cents back to non-GAAP EPS.

What to Watch

- Inventory DSI reached 47 days. That's up from 43 after 3Q, but still below a normal level of about 55 days. The lower production rate likely helped raise the DSI figure and 43-44 days is probably still a realistic way to view where inventory stands. Per management, it sees some return from Chinese demand and some plants operating at higher levels of capacity. That likely still means that LYB could see some cash flow headwind from rebuilding inventories by $700 million to $1 billion. Working capital freed up over $500 million in cash during 4Q, which could reverse.

- LYB is cautiously optimistic about its North American cost edge getting stronger. China reopening could drive oil demand and plastic demand higher. Higher pricing should remove the LCM charges (perhaps not completely in Europe):

  CEO on the earnings call:

  > *"When we talk about China, it's still early stage to say that we see a sustainable recovery. We expect -- I mean that, that will take probably another 3, 4 months until we see that recovery is actually happening. So we're still very modest in our expectations on China. But at least, I mean, we know that there has been the opening."*

  EVP of Global O&P on the earnings call:

  > *"NGL production continues to increase. So we expect that to be a tailwind, especially for our position here in North America. The oil and gas ratio is going to be continue -- or continue to be favorable for our portfolio.*
  >
  > *We don't see that really changing. We do expect there could be some strengthening in the oil price as we go through the year just as demand potentially comes back with China reopening. So all in all, I would say that the environment today should be better than where we were in the second half of last year around feedstock synergy in our portfolio."*

- 2023 is expected to be a heavy year for the maintence of plants for LYB. That should restrain some production longer than normal. LYB is forecasting it will lose about $290 million from major maintenance programs this year. However, with the completion of the new PO/TBA plant, total capital spending should decline by $300 million vs. 2022 to $1.6 billion with $1.1 million going to maintenance and $0.5 million to growth projects.

- LYB is still calling out that it plans to pull $750 million in costs out of operations by 2025 – that becomes a reasonable tailwind.

- The logistics to export more from the US also appears to be a tailwind for 2023. North American chemicals using natural gas feedstocks have a decided edge in lower costs than Asia or Europe.

  CEO on the call:

  > *"**Normalizing supply chains are enabling improved trade flows from our advantaged feedstock positions in North America and the Middle East.** Nonetheless, we will*

> *continue to maintain focus and discipline to ensure that operating rates across our global portfolio are matched to market conditions."*

EVP of Global O&P on the earnings call:

> *"during the quarter, **we actually did see both as an industry but in LyondellBasell as well an increase in exports.** Some of that was related to some improvement in demand overseas, some less imports coming into some of the closer markets like South America from other regions.*
>
> ***But also the relief of some of those [indiscernible] logistics constraints that we were dealing with in the first 3 quarters of the year, it really started to free up in the fourth quarter.** So I think that you're going to start to see that continue in the first quarter and we'll get back to a more normal level of exports for 2023."*

- The refinery is still expected to close by the end of 2023. It may see reductions in production throughout 2023 or it may be heavily weighted to 4Q – management has not confirmed a timing schedule. However, it still sees the cost of maintaining the refinery as too high to justify keeping it open.

  This is always been a lumpy business based on the spread between heavy crude and intermediate crude (Maya spread) and the difference between gasoline/diesel prices vs crude prices (Crack spread). In recent quarters the Maya spread has been $8-$17 per barrel – vs historical periods of under $4. Crack spread has been running over $30 in recent quarters vs historical periods of around $10.

  The result is recent quarters for the refinery have been a meaningful part of LYB's EBITDA and that will go away. We don't want to make this out to be the end of the world, the refinery operation had many years of losing money. In 4Q22, refining was $249 million of the $865 million in EBITDA. In 2022, refining was $921 million of the $6.5 billion in EBITDA.

- Mid-cycle EBITDA is still expected to be $9 billion or better with the cost savings. At $100/share – LYB is trading for 4.7x EBITDA. Debt is less than 1x EBITDA and it should generate free cash flow > $4 billion. The dividend is only $1.5 billion of that despite already paying a 4.8% yield, which gives it plenty of cash flow to repurchase shares, fund growth, or pay special dividends – all of which LYB has done.

Stryker Corporation (SYK)
Earnings Quality Update

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

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

Summary

SYK reported non-GAAP EPS of $3.00 which was 16 cps ahead of consensus with revenue coming in $235 million better than expected. Management noted strong orders during the end of the quarter and it anticipates the momentum will continue into next year.

We saw some one-time benefits which helped boost results in the quarter but the beat remained well intact after adjustment. Still, we leave our 3- (Minor Concern) earnings quality rating in effect reflecting the company regularly adding back material restructuring charges and its practice of adding back amortization of intangible assets to non-GAAP results despite acquisitions being a part of its growth strategy.

Our observations on the quarter follow:

- **The adjusted tax rate of 13.8% was likely below what analysts were expecting.** The company stated in the third-quarter call that it expected the full-year rate to be at the low end of its 14.5% to 15% guidance range. Given the tax rates for the first three quarters (13.9%, 13.9%, and 14.5%), we believe analysts were likely expecting the fourth quarter rate to be closer to 15% which would have taken about 6 cps off EPS in the quarter.

- **The allowance for bad debts fell to 4.1% of gross receivables in the quarter, down from 4.6% in the previous quarter and 5.2% in the year-ago period.** SYK increased its allowances from the pre-Covid 3% range to about 5% and is now taking them back down which is providing a tailwind to earnings. If the reserve percentage had remained level with a year ago, we estimate it would have shaved over 3.5 cps off earnings. The company should have another quarter or two of this benefit before the allowance percentage levels out. ***(See below for details)***

- **Adjusted other expense declined by about 2.5 cps** which we suspect was due to an increase in gain on investments.

- **We remind clients that SYK regularly adds back restructuring charges to its non-GAAP results**. Restructuring charges jumped to 24 cps in the quarter. The company also added back over 32 cps in amortization of acquired intangibles despite acquisitions being part of the company's strategy. If the company had to develop the IP picked up in these acquisitions in-house, it would have to expense it on the income statement. Ignoring the amortization expense expensing any cost associated with obtaining the acquired IP. We believe all of this weakens the company's earnings quality.

- **The company took a $216 million impairment to the value of goodwill and intangibles associated with its Spine unit.** It attributed this to "slower than anticipated recovery of surgery volumes as we emerge from the COVID-19 pandemic, the competitive pressures in the spine market, and rising interest rates in the current macroeconomic environment." The company also disclosed that a further 1% increase in interest rates will result in another $220 million in impairment charges.

- The company announced it is exiting the Spine business in China after losing the bidding on the VBP contracts. This should be viewed as a positive given the company has warned that bidding on these contracts can result in unattractive terms.

Bad Debt Allowance Down

The following table shows SYK's allowance for bad debts as a percentage of gross receivables for the last sixteen quarters:

	12/31/2022	9/30/2022	6/30/2022	3/31/2022
Net Receivables	$3,565	$3,103	$3,145	$2,991
Allowance for Doubtful Accounts	$154	$150	$144	$140
Allowance for Doubtful Accounts % of Gross Receivables	4.1%	4.6%	4.4%	4.5%

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Net Receivables	$3,022	$2,817	$2,714	$2,616
Allowance for Doubtful Accounts	$167	$146	$141	$132
Allowance for Doubtful Accounts % of Gross Receivables	5.2%	4.9%	4.9%	4.8%

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Net Receivables	$2,701	$2,426	$2,203	$2,646
Allowance for Doubtful Accounts	$131	$125	$114	$100
Allowance for Doubtful Accounts % of Gross Receivables	4.6%	4.9%	4.9%	3.6%

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Net Receivables	$2,893	$2,438	$2,408	$2,284
Allowance for Doubtful Accounts	$88	$75	$70	$67
Allowance for Doubtful Accounts % of Gross Receivables	3.0%	3.0%	2.8%	2.8%

Like most companies, SYK took its allowances up during Covid and is now bringing them back down to more normal levels. We don't know what the actual provision expense is so we can't calculate the exact impact on EPS, but if the reserve has remained at year-ago levels, we estimate it would have taken about 3.6 cps off EPS in the quarter. The reserve percentage of 4.1% is still above the pre-Covid norm of about 3%, so the company should get another couple of quarters of benefit from reducing reserves at which point it should level out.

Steris plc (STE)
Earnings Quality Update

We are downgrading our earnings quality rating of STE to 3- (Minor Concern)

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

Summary

STE missed the consensus EPS estimate in the third fiscal quarter ended in December by 17 cps. It also came up over $50 million short of the revenue target which it blamed on shipment and customer delays with those sales now expected to be realized in the next quarter.

The adjusted tax rate was 23.5%. The company's original guidance for the full fiscal year ended March was for 22% so we estimate this was likely an approximate 4 cps headwind not expected by the Street with a couple of other minor one-time items that essentially offset each other. However, our concern is related to an unusual increase in receivables which seems to be at odds with the company's explanation for the sales shortfall.

- Accounts receivables DSO's rose by five days year-over-year and three days sequentially. While the absolute DSO level is not concerning compared to pre-Covid levels, the fact that receivables increased by more than $40 million sequentially while sales were flat both YOY and sequentially does not seem to match the company's narrative that $50 million of orders were delayed until the next quarter. Also, the company noted in the conference call that it is not having difficulty collecting receivables. This makes us wonder if revenue was helped by an unusual surge from other areas late in the quarter that might have been pulled into the current quarter. ***(See detail below)***

- Warranty expense declined by 1.9 cps which we would not expect to continue.

- Almost offsetting the warranty tailwind was a 1.4 cps headwind from an increase in the allowance for bad debts as a percentage of gross receivables to 3%. This is above the 2% pre-Covid level which could provide a minor boost to earnings in upcoming quarters if the company reverses some of this into earnings.

- Inventory DSIs are now at 92 days versus 81 a year ago and closer to 50 pre-Covid. Management discussed in the call how this has been due to delays in shipments and lower-than-anticipated sales. We would expect this to come down in the next quarter if the delayed shipments are fulfilled. ***(See detail below)***

Account Receivable Shows an Unusual Increase

Accounts receivable DSOs were up by five days year-over-year to 62. Consider the following table which shows receivables and DSOs for the last sixteen quarters:

DSO	12/31/2022	9/30/2022	6/30/2022	3/31/2022
Revenues	$1,216	$1,201	$1,156	$1,211
Trade Receivables	$823	$780	$764	$799
Trade Receivables Days of Sales	62.2	59.8	60.1	59.4
	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Revenues	$1,209	$1,197	$968	$874
Trade Receivables	$752	$762	$743	$609
Trade Receivables Days of Sales	57.2	58.6	69.9	62.8
	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Revenues	$809	$756	$669	$823
Trade Receivables	$556	$504	$503	$586
Trade Receivables Days of Sales	63.2	61.3	68.5	64.8
	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Revenues	$774	$737	$697	$768
Trade Receivables	$544	$513	$510	$565
Trade Receivables Days of Sales	64.7	64.1	66.6	66.2

STE did finalize the sale of the Renal Care business in January 2022 so the 12/21 quarter had $47 million in revenue from this source which is not present in the 12/22 quarter. However, that should have had a minimal impact on the year-ago DSO number and no impact on the sequential trend in the 12/22 quarter.

We note that the DSO of 62 is not high compared to pre-Covid levels. However, receivables increased by $43 million sequentially in the 12/22 quarter on essentially flat revenue which was about $50 million short of consensus. The company blamed the revenue shortfall on very specific revenue sources that were delayed due to shipping problems and customer delivery issues. Consider these quotes from the call:

> *" Approximately $30 million in capital equipment shipments were delayed into the fourth quarter."*
>
> *"Regarding Mevex, a large E-Beam capital equipment order of approximately $10 million was delayed into Q4, as our customer was not ready to receive the unit."*
>
> *"In addition, Life Sciences had an unanticipated shipping challenge out of Europe that limited capital equipment growth in the quarter by about $10 million."*

The fact that revenue fell so far short of the mark makes the large sequential increase in receivables look suspicious. In our mind, the only benign explanation for the increase in receivables is that collections slowed considerably during the quarter. When asked on the call about free cash flow falling below forecast for the year, the company blamed it on both higher inventory and higher receivables. Management made the following comment:

> *"And then on the receivables side,* ***it's not our inability to collect. It's just the timing of collections.*** *We have about just under a 60-day DSO that we have collection.* ***So, originally, we anticipated shipping earlier or more product in the third quarter [12/22]. That has shifted to the fourth quarter [3/23], which pushes collections into the first quarter [6/23]****. So, free cash flow isn't lost. It's just more of a timing issue."*

The timing of collections management is addressing in the above quote seems to be related to sales that were not made yet rather than the timing of collections of receivables generated during the quarter. Obviously, the receivables related to the delayed sales couldn't be collected because they weren't even generated before the end of the quarter.

The comment also seems to imply that collections of existing receivables didn't slow. So where did the extra receivables come from? We wonder if there was a surge of revenue recognized late in the quarter from another source that was not identified. Investors will be looking for the delayed $50 million to be recognized in 4Q23. The risk is that this surge of orders could represent sales that were pulled forward into 3Q23 which could be an unexpected damper on sales growth in 4Q23.

Inventory Keeps Rising

The following table shows inventory DSIs for the last sixteen quarters.

	12/31/2022	9/30/2022	6/30/2022	3/31/2022
DSI	92.0	88.8	88.4	81.0

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
DSI	81.5	72.5	99.5	57.4

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
DSI	58.4	60.2	66.1	52.1

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
DSI	52.4	52.1	54.4	43.2

Note that the company switched to FIFO from LIFO inventory accounting in the 3/21 quarter. Our DSI figures do not reflect inventory adjusted for this change in the periods before that but this should have had a minimal impact on DSO for comparison to pre-Covid levels.

Inventories have risen for some time and management discussed the inventory build on the call:

> *"Obviously, as we have not been able to ship at the rates we anticipated, we are carrying more inventory, as we've talked many times the last couple of quarters. We continue to fill our manufacturing slots. So we're building, building, building, waiting for that golden screw. But that golden screw doesn't come, that product remains in inventory until we ship it. So, inventory has continued to be elevated."*

Deliveries have been impacted by shipping delays and supply chain issues as well as lower than anticipated demand from elective procedures and vaccine production. If the identified delayed orders from 3Q ship, we expect to see inventory begin to work its way down next quarter and will be concerned if it remains elevated.

Teva Pharmaceutical Industries Limited (TEVA)

Earnings Quality Update

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

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

Summary

TEVA's 4Q22 adjusted EPS of $0.71 hit guidance. As we have discussed, it is no longer a given that TEVA can simply lower its sales allowances to generate earnings. We see many reasons to view 4Q earnings as poor:

- New sales allowances exceeded the amount used by $102 million – which was an 8-cent headwind. Offset by:
- TEVA added back accelerated depreciation which added 3 cents to EPS.
- TEVA saw R&D fall as a percentage of sales and in dollar terms adding 2-3 cents.
- TEVA saw sales and marketing fall as a percentage of sales and in dollar terms adding 4-7 cents to EPS.
- The company lives in court and considers that a part of its operating model. However, it adds back lawsuit expenses – which was 2 cents of adjusted EPS.
- A mysterious jump in "other non-GAAP" items added back that included other accelerated depreciation and inventory write-offs of $98 million added 7 cents.

Investors should also take note that TEVA's guidance is flat guidance for 2023 with adjusted EPS of $2.25-$2.55 vs. $2.52 and EBITDA of $4.5-$4.9 billion vs. $4.6 billion.

What to Watch

- Reducing Sales Allowances is no longer a constant source of EPS for TEVA. The company is starting to have quarters where the accrual of new expenses exceeds the amount used.

	4Q22	3Q22	2Q22	1Q22	2022	2021	2020	2019	2018
New Sales Allowance	$3,298	$3,147	$3,382	$3,088	$12,915	$13,426	$14,415	$16,767	$18,899
Allowance Used	$3,196	$3,379	$3,309	$3,522	$13,406	$14,009	$15,750	$17,319	$20,069
Net change	$102	($232)	$73	($434)	($491)	($583)	($1,335)	($552)	($1,170)
EPS Impact	($0.07)	$0.19	($0.06)	$0.32					

For a company earning about $2.50 in EPS – it is obvious that reducing this account has been a big source of TEVA earnings. It is also a big part of the $4.5 billion of EBITDA. Guidance is for sales to rise driven by Austedo, which may require more sales allowance accruals in 2023.

- Debt is NOT falling nearly as much as management claims. Litigation accruals are rising fast and TEVA was already selling European receivables to raise cash and in November started selling US receivables too. That adds to cash from operations and boosted the cash on hand:

	4Q22	4Q21
LT Debt	$21,212	$23,043
Litigation Accrual	$4,186	$2,710
Total Debt	$25,398	$25,753
Cash on Hand	$2,801	$2,165
A/R sold Europe	$636	$685
A/R sold US	$820	$0

Cash from operations and free cash flow both grew with the new $820 million in cash received from selling more receivables. For the 4Q, cash from operations and free cash flow grew y/y by $517 million and $424 million. For the year, it was $792 million and $47 million. So the extra $820 million deal made a material difference.

- Look at the declines in discretionary spending items too. TEVA says that marketing and research are vital to its future growth, yet these continue to decline and are helping recent earnings figures. Every $50 million is worth 4 cents in EPS:

	2022	2021	2020	2019	2018
R&D	$838	$967	$997	$1,010	$1,213
Sales Marketing	$2,265	$2,429	$2,498	$2,614	$2,916
Advertising	$168	$246	$225	$213	$256

- At the same time, Royalty expenses are rising:

	2022	2021	2020	2019	2018
Royalty Exp.	$560	$522	$505	$403	$536

- Impairments continue at TEVA. It is blaming FX issues with a stronger dollar hurting profits overseas and a rising discount rate.

Impairments	2022	2021	2020	2019	2018
Goodwill	$2,045	$0	$4,628	$0	$3,027
Intangibles	$355	$424	$1,502	$1,639	$1,991
PP&E	$47	$160	$416	$139	$500

It is worth noting that TEVA still has $17.6 billion in goodwill and $6.3 billion in intangibles on the books. Also, it noted that in 2Q22 that it did not take an impairment on Goodwill in Europe as the value exceeded carrying value by 9% using a 10.04% discount rate, but 50bp of increase would reduce the cushion to only 5%. TEVA does not give the discount rate every year (sometimes saying it is based on the weighted cost of capital), but we saw that in 2019 it was using a rate of 9.52% in Europe and 9.80% in International markets and for 2020, it was using 7.5%-9.0% for other intangible assets. It sounds to us that by 2Q23, the discount rates should be expected to be much higher when TEVA does its next impairment test.

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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