BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

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Church & Dwight (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 adjusted EPS of $0.62 beating the consensus estimate by 2 cps. Revenue topped the consensus by about $35 million, which the company attributed half to FX and half to better-than-expected performance from the acquired *Hero* brands. We saw no significant earnings quality items impacting the beat in the quarter and while acquisition risks remain, we still consider CHD's earnings quality to be one of the highest in the CPG companies we follow.

We note the following observations on the quarter:

- **Inventory days of sales was 71.4 which is a marked improvement from the third quarter's 80.9 but still elevated compared to the pre-Covid low 60s range.** We have highlighted the build in inventories resulting from weaker Flawless and Waterpik sales but it appears this is correcting. We will be looking for the trend to continue into the next quarter.

- Management indicated in the third quarter that it had built inventory reserves in the second and third quarters. It only reports the actual reserve amount in its 10-K which was $46 million, or 7.1% of gross inventory for 2023. This is up from 6.8% in 2021 but considerably above the 3.4% in 2020. This could result in an earnings tailwind in upcoming quarters if the company reverses some of this reserve into earnings.

- **Marketing expense came in at 13.2% of sales which is consistent with management's outlook after the last quarter.** CHD enjoyed lower-than-expected marketing expenses in the last couple of quarters. That benefit has ended and is now reversing as the outlook for 2023 calls for marketing expense of 10.5% of sales versus about 10% for all of 2022 which will be a 3% drag on earnings growth. Higher incentive compensation is expected to be another 3% headwind to growth in 2023.

- **We note that the company changed its disclosure on receivables factoring.** Before the most recent 10-K, data on factored payables was reported annually and the company disclosed only the incremental amounts of receivables that were factored. The latest 10-K instead shows the total amount of receivables that were factored during the year which was $211.2 million, up from $181.2 million and $160.0 million in 2021 and 2020, respectively. We are not especially concerned by the increase in the rate of factoring although we would prefer the company to also disclose the amount of receivables that are factored but still outstanding.

- **The company is backing off on pricing.** Management noted in the call that while it had price increases going into effect in January and February, it does not have any more solid plans for more price increases in 2023. It specifically noted that "it's becoming exceedingly more difficult in order to push price through and get away."

- **Higher promotional spending will also be a drag on net pricing.** Management noted that promotional spending has been up since the first half of the year. Specifically, liquid laundry detergent sold under deal was 33.4% in 4Q versus 28% in 2Q. It is expected to rise to its historical mid-30% range during the year. Likewise, cat litter sold on deal was 14% in 4Q versus 11.5% in 2Q. The historical norm is in the high teens.

- **Hero is reportedly performing better than expected.** CHD closed on the deal on 10/13/2022 and management indicated that the brand performed better than anticipated which contributed to CHF's above-consensus sales growth in the quarter.

- **The company took a $411 million impairment charge to the Flawless goodwill.** We warned this was likely in our last review. Acquisitions remain an important part of the company's growth strategy which is a risk not shared by some of the other larger CPG companies. Management has not shied away from calling the Flawless deal a mistake and kicking itself over buying a high-end, asset heavy brand rather than its typical quick-moving consumable product lines. The initial performance of Hero is encouraging but it remains to be seen if Waterpik will pull out of its pandemic rut.

Cloudflare, Inc. (NET)
Earnings Quality Update

We are maintaining our earnings quality Rating of NET of 2- (Weak).

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

Summary

NET's 4Q22 adjusted EPS of 6 cents beat forecasts by 1 cent. It reported a 6.1% adjusted operating margin – a large improvement. We're not sure the beat is completely solid and guidance is not very strong with 1Q23 expected to post 3-4 cents in EPS and a 4.0-4.3% operating margin:

- Stock compensation added 2 cents more to adjusted EPS than in 3Q22.

- Interest income is real money, but it was 2.2 cents of EPS in 4Q. It's not operating income and no one is paying the multiple NET is trading for to collect interest income.

- Cash spending for R&D and Sales & Marketing increased in dollar terms after dropping in 3Q, but still came in below normal levels by at least 200bp. That would account for 1.5 cents of EPS:

	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Cash R&D	$49.4	$46.4	$46.2	$40.3	$37.0	$32.8
Cash S&M	$113.0	$103.5	$103.9	$89.7	$86.0	$77.6
Sales	$274.7	$253.9	$234.5	$212.2	$193.6	$172.3
R&D %	18.0%	18.3%	19.7%	19.0%	19.1%	19.0%
S&M %	41.1%	40.8%	44.3%	42.3%	44.4%	45.0%

- The 6.1% adjusted margin is expected to decline 200bp for 1Q23 guidance and for the full year of 2023.

- Even with solid deferred revenue growth, sequential sales growth continues to decline and forecasts of $290-$291 for 1Q23 points to falling under 6%:

	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Seq. Sales Growth	8.2%	8.3%	11.1%	10.1%	12.4%	13.1%
Seq Def Rev Growth	27.9%	11.1%	18.5%	13.2%	24.9%	14.7%
Def Rev Days Sales	77.2	65.3	63.1	58.2	57.6	51.8

- Free cash flow was a positive $33.7 million. Normally, NET cannot even report positive cash from operations without adding back stock compensation. We still consider 4Q22 less than impressive for several reasons.

	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Cash from Ops	$78.1	$42.7	$38.3	-$35.5	$40.6	-$6.9
Capital Spend	$40.1	$41.9	$37.1	$24.5	$28.3	$28.8
Software Spend	$4.3	$5.4	$5.6	$4.5	$3.6	$4.0
Free Cash Flow	$33.7	-$4.6	-$4.4	-$64.4	$8.6	-$39.7
Stock Comp	$62.6	$55.9	$57.5	$41.8	$42.1	$28.0
Def. Rev Growth	$50.3	$17.4	$25.5	$16.0	$24.2	$12.4
Int. Income	$8.3	$3.9	$1.6	$1.1	$0.7	$0.4

  - Normally deferred revenue adds $15-$25 million to cash from operations. It was $50 million in 4Q. If that was a normal $15-$25 million, cash from operations again would have been less than the stock compensation.

  - Interest income is now 10% of cash from operations.

  - Capital spending on both equipment and software is down.

The Coca-Cola Company (KO)
Earnings Quality Update

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

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

Summary

KO's adjusted 4Q22 EPS of $0.45 met forecasts and was flat y/y. On earnings quality, we consider this a miss:

- Pension income was down to $16 million from $51 million for a 0.7-cent headwind. Plus, KO is guiding to pension income going from $124 million in income for 2022 to a $40 million expense in 2023 – starting 2023 with a 3-cent headwind.

- KO claims it is spending more on marketing, up $221 for the year - but prepaid marketing was down y/y by 2% and the only quarter with higher marketing expense was 3Q, up $278 million. For 4Q, advertising declined $170 million y/y adding 3.2 cents to EPS.

- Depreciation and amortization fell by $34 million – about 70% of the decline is depreciation – adding 0.6 cents to EPS.

- Stock compensation fell by $18 million y/y, adding 0.3 cents to EPS.

- The guidance does not "wow" with revenue growth of 7%-8% before FX of 3% and mid-single-digit commodity inflation.

What to Watch

- KO finally ramped up inventory in 4Q by 10 days and is back to normal levels.

	4Q22	4Q21	4Q20	4Q19
Inventory	$4,233	$3,414	$3,266	$3,379
Adj. COGS	$4,440	$4,042	$3,661	$3,605
DSIs	87.7	77.7	82.1	91.3
Gross Margin	56.5%	57.3%	57.4%	60.3%
Pricing	12%	10%	-3%	5%
FX	-8%	-1%	-2%	-2%

The problem may be that by waiting so long, KO may have finally ramped up inventories as commodity costs are moving back down. With FIFO and Average Cost accounting, this could continue to pressure gross margins. KO is guiding for y/y price hikes to decline through 2023. It even noted that any pricing won't be automatic. According to the CEO,

> *"So in **the developed markets, it's likely we'll trend more back towards more standard cycles of pricing**, but there will be price increases across the world in 2023 to reflect both the continuing inflation in import and SG&A costs. **Obviously, we need to, as I talked about in the previous answer, earn the right to that pricing,** but there will be pricing in 2023."*

KO says it will need to spend more on marketing to boost pricing and lower marketing helped in 2022 except for 3Q.

- Gross margin has been helped by lower depreciation after years of spending less than normal levels on new PP&E. KO is guiding to $1.9 billion in capital spending for 2023, so this earnings driver may start to reverse. KO has picked up 132 bps from this source since 2020. Every 50bp of increase is about 4 cents of EPS headwind:

	2022	2021	2020	2019	2018	2017
Capital Spending	$1,484	$1,367	$1,177	$2,054	$1,548	$1,750
Depreciation	$1,125	$1,262	$1,301	$1,208	$999	$1,131
Depreciation % Sales	2.62%	3.26%	3.94%	3.24%	2.91%	3.12%

- Latin American pricing less FX is driving a material amount of EPS. We believe this will revert to a normal relationship. In 2018, Latin America had 10% pricing and -9% FX. In 2019, it was 13% pricing and -10% FX. Covid really destroyed it with 2% pricing for 2020 with -14% FX. In 2021 and 2022, this has been an abnormal situation:

Latin America	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Volume Growth	6%	6%	-4%	20%	-10%	11%	29%	2%
Pricing Growth	26%	12%	12%	19%	11%	23%	9%	7%
FX	-7%	-6%	-1%	-6%	1%	7%	3%	-10%

Pricing exceeded FX losses by 19% in 4Q22 which is a record spread. This should be closer to 2%-5%. Every 500bp this spread declines – it would cost KO 1 cent in quarterly EPS. We'd make an argument that KO picked up 3 cents here in a quarter where it only met forecasts.

It's worth noting that other foreign markets are already showing more normalcy at this point too. APAC in 2022 had 3% pricing and -9% FX with 4Q22 of 7% and -14%. EMEA was 16% pricing and -14% FX in 2022 and 15% with -16% for 4Q22.

- The tax dispute appears to be coming closer to an end. This relates to allocating costs and profits between US and foreign units and the IRS challenged KO's taxes. 3M had a similar case that the Tax Court needed to resolve first. This happened on February 9, 2023, and KO expects the court to soon issue a ruling on KO's case.

  KO plans to appeal the decision. In past 10-Ks, KO noted it may have to post $4 billion in cash to file the appeal. In the 2022 10-K, KO noted that the dispute could now be $5.2 billion. The company has accrued $423 million at this point.

  KO's guidance is for free cash flow of $9.5 billion in 2023. Its dividend is over $7.6 billion. If it needs to post $4-$5 billion in cash, it would seem unlikely to repurchase many if any shares in 2023 which could become a headwind for forecasts.

Colgate-Palmolive Company (CL)
Earnings Quality Update

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

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

Summary

CL reported non-GAAP EPS of 77 cps in 4Q22 which was in line with the consensus. As we have noted in the past, CL has managed to report earnings for the last several quarters that are right at the consensus target with much greater precision than its peers. In our minds, this increases the likelihood of earnings management and makes the minor one-time benefits noted below more of a concern than they would be for companies with seemingly less precise forecasting ability.

- **The allowance for doubtful accounts as a percentage of gross receivables fell to 4.4% versus 5.7% in the year-ago period.** We have noted in past reviews that the company raised its allowance percentage to the mid-6% range during the pandemic from the more normal mid-5% pre-Covid level. The current 4.4% is well below that level. The company does not disclose quarterly provision expense, but the 10-K revealed that for the year, provision expense was only $4 million versus $35 million in 2021. This alone represents a 3 cps benefit which likely was concentrated in the back half of 2022. Not only will the tailwind of lower provisions on new receivables fade, but it could also very well reverse if a slowing economy forces the company to increase allowances to their more normal pre-Covid range.

- **A decline in adjusted other expense added 2.3 cps to EPS growth in the quarter.**

- **The non-GAAP effective tax rate came in at 22.2% which we estimate could have added about a penny per share to earnings relative to the consensus expectation.** After the third quarter, the company's outlook called for the full-year effective rate to fall in the 23.5%-24.0% range which would have required an approximate 23.5% rate for the fourth quarter.

- **Lower stock compensation expense added another penny per share.**

- **Inventory DSIs fell sequentially to 93 days from 100 in the previous quarter which is a step in the right direction**. While this is still up from the pre-Covid level of 70-80 days, the normalization is good to see as the company uses FIFO accounting for 75% of its inventory and it risked getting stuck with higher cost goods being sold at a time retailers are beginning to show signs of pushing back on price increases.

- **CL took a $721 million pretax impairment charge related to its Filorga intangible assets.** We warned this was likely in recent reviews. While partly due to decreased forecasts related to the China lockdown, the impact of higher discount rates on fair value calculations was a contributor as well.

- **Pricing accelerated in the quarter along with the volume declines.** CL raised prices 12.5% and saw organic volumes fall by 4%. This trend was especially on display in the Hill's pet food unit where 13.5% price increases resulted in organic unit growth of only 0.5%. The company continues to expect higher pricing in the first half of the year which will be a drain on volumes. Not surprisingly, the benefit from lower advertising expense is also expected to reverse in 2023 as it is expected to increase both in dollar terms and as a percentage of revenue.

- **Latin America continues to benefit from likely unsustainable price increases**. Net pricing in Latin America rose by 19%. Organic volume fell by 7% which still resulted in solidly positive net organic growth. However, FX was only a 2 percent drag in the period compared to mid-teens headwinds just a few quarters ago calling into question the longevity of the strategy.

Iron Mountain (IRM)
Earnings Quality Update

We are maintaining our earnings quality rating of IRM of 1- (Strong Concern).

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

Summary

IRM's 4Q22 FFO of $0.74 was flat y/y down 2 cents sequentially and missed forecasts by 1 cent. AFFO was $0.98, up 6 cents y/y and flat sequentially. We will need the 10-K to do a full look at results, but we already consider this a larger miss than the market:

- IRM cut maintenance capital spending by $9.4 million y/y and $2.6 million sequentially. This helped AFFO by 3.2 cents and 0.9 cents.
- We estimate that ignoring principal payments on financing leases added $8.8 million, or 3.0 cents, to both FFO and AFFO.
- Adding back recurring stock compensation helped both FFO and AFFO by 3.7 cents.
- We noticed 4Q22 was the first time IRM added back derivative amortization. This $9.1 million helped FFO and AFFO by 3.1 cents. This is likely a new item related to more international exposure.
- Non-cash rent expense rose y/y by $3.9 million to $6.0 million. This is part of the inducement giveaways to steal customers. It was 2.1 cents in AFFO for 4Q22, with the y/y increase being 1.3 cents.
- We do not know the full amount of cash inducement spending in the quarter or the increase in lease expense.
- Boosting price on the records storage business also drove results. Volume was up only 0.4% with pricing up 10.6% - Every 1% of pricing adds 2.5 cents to FFO and AFFO.

Guidance does not wow us either. 4Q results annualized would be EBITDA of $1.89 billion vs. guidance of $1.94-$1.98 billion. That's 3%-5% growth – the same as forecasted AFFO gains.

What to Watch

- Much of the growth coming out of Covid was for services. This is picking up, organizing, delivering, destroying documents. This source of revenue has now declined for three straight quarters.

Service Growth	4Q	3Q	2Q	1Q
2022	$509.6	$526.6	$536.4	$497.0
2021	$434.4	$411.5	$401.5	$374.0
2020	$362.4	$340.4	$305.3	$385.2
2019	$404.1	$388.9	$397.6	$390.9
2018	$402.6	$404.0	$405.4	$391.3

- IRM is not immune from recession. It used to tout that volumes in storage remain very sticky and that from 2006-10, it had positive volume growth. However, we found that from 2008-10, IRM had negative volume changes of about 2% per year. Also, IRM noted that during that time, customers pulled volumes out or had more destroyed to end their storage fees. Plus, new volumes came in more slowly and the lead time to win new business grew longer. We believe that also bodes poorly for continued large price hikes in this unit.

- People own IRM for its dividend of 61.85 cents per quarter. This dividend used to grow at 5%-7% annually. It's been flat since October 2019. We have pointed out several times that the 98 cents in quarterly AFFO looks overstated as it excludes too many cash fulfillment costs. Plus we know without the 10-K, AFFO picked up 25 cents from price hikes, 3 cents each from spending less on maintenance and ignoring financing lease principal payments, with another 10 cents of other items before we even see the cash fulfillment costs that are left out of AFFO.

Keurig Dr Pepper Inc. (KDP)
Earnings Quality Update

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

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

Summary

KDP's 4Q22 adjusted EPS of $0.50 missed by 1 cent. This is after just meeting forecasts for the first three quarters of 2022. We see several areas helping earnings that may be difficult to maintain:

- **KDP uses finance leases** and the principal payments are rising. This does not show up as an expense and it was $25 million in 4Q22, up from $14 million y/y. **This added 1.4 cents to EPS.**

- **KDP's stock compensation dropped y/y from $20 million to $14 million.** It adjusted out $4 million last year and only $2 million in 4Q22 – creating a $4 million decrease or 0.2 cents in EPS. For 1Q23, investors should remember that KDP booked a $15 million credit for stock compensation in 1Q22.

- **Marketing and R&D have been lower since Covid.** They only quantify this in the annual results. On the earnings call, **management pointed to a large increase in marketing coming in 1Q23. $50 million of this type of expense is about 3 cents in EPS for KDP.** We think the company is still $100-$150 million light:

	2022	2021	2020	2019
Advertising	$537	$540	$489	$670
R&D	$65	$66	$69	$81

- **KDP is also taking pricing in excess of FX losses in Latin America. Every 500bp is about 0.5 cents per quarter.** This has been an anomaly in our view.

Latin Am	4Q22	3Q22	2Q22	1Q22
Price	13.2%	17.3%	14.5%	9.6%
FX	-6.5%	-1.9%	0.0%	-0.8%

- **Restructuring/Integration and Productivity plans continue to be a material amount of EPS** that is added back to adjusted earnings despite it being years since the last deal. Shouldn't these get smaller?

Productivity	4Q	3Q	2Q	1Q
2022	$0.03	$0.03	$0.03	$0.03
2021	$0.03	$0.02	$0.02	$0.02
Restruc/Integration				
2022	$0.04	$0.02	$0.01	$0.02
2021	$0.03	$0.03	$0.03	$0.02

Integration is normally right-sizing real estate and headcount plus merging computer systems and H.R. departments. It's been going on for 4-5 years- isn't this done? Productivity can involve better ways to buy marketing or warehouse space. Some of that seems likely to include items like up-front investments or buying in bulk. That could be ongoing costs that are simply being put into a charge and added back. Also, the rate of change for any improvement should stall as it annualizes.

- **Falling depreciation is being offset by higher lease expense. KDP has been selling off assets in sale-leaseback transactions.** Is this really helping earnings?

Depreciation	4Q	3Q	2Q	1Q
2022	$98	$96	$99	$106
2021	$106	$98	$104	$102
Lease Expense				
2022	$72	$68	$68	$65
2021	$61	$57	$60	$54

- **A few impairments hit in 2022 – shouldn't the discount rate be rising more?** KDP has $20 billion in goodwill and $22 billion in indefinite-lived intangible assets. It recorded impairments of $311 million on the *Bai* and $166 million on the *Schweppes* brand names

last year. We noticed that despite the surge in interest rates, KDP hasn't changed its discount rates very much after a steep drop in 2020:

Discount Rate	Range
2022	7.3%-10.3%
2021	6.5%-10.0%
2020	6.0%-10.0%
2019	7.25%-13.0%

- **Payables have reached 268 days now.** KDP has a factoring set-up for suppliers to sell their KDP debt and collect cash more quickly. Suppliers have sold $3.8 billion, or 198 days of KDP's payables. There is no comment concerning the rising cost of doing this to the suppliers. Two years ago, this was essentially free at 10-15bp. Now, it is likely 5%-6%. We still believe this is debt that KDP may be forced to deal with this on short notice.

- **Total debt continues to be misleading. KDP only focuses investors on bank and bond debt less cash.** We believe the factored payables of $3.8 billion should be included as well as structured payables (a corporate credit card) of $137 million, and the PV of finance leases of $713 million should be viewed as debt too. KDP says its debt/EBITDA ratio is only 2.8x based on $11.6 billion of net debt. We calculate debt at $16.3 billion which results in a debt/EBITDA of 4.0x. Investors should also remember that KDP spent the cash it pulled in from the factored payables and all the sale-leasebacks that are boosting lease payments. Cash is only $535 million and the dividend is $285 million per quarter.

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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