BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

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DocuSign, Inc. (DOCU)
Earnings Quality Update

We are maintaining our earnings quality rating of DOCU of 4- (Acceptable).

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

Summary

DOCU's adjusted EPS of $0.65 in 4Q23 beat estimates by 13 cents. About 3 cents came from higher interest income, which is a function of the FED, not DOCU's operations. We also think something that was lost on the quarter's news was DOCU posted a positive GAAP EPS of 2 cents. There remain negatives and positives as this company continues its transition to a more trained sales force, more product innovation, and greater adoption of products throughout customer organizations.

- Adjusted Operating Margin came in at 23.6% vs. forecasts of 20-22%. The recent restructuring to reduce headcount played a big role there. Given that 3Q23 results were also a 23.6% margin, we think guidance was too low. The 160bp over guidance was worth 4 cents in EPS.

- Subscriber Revenue beat handily by $15.7 million. That added 1.5 cents to EPS. Again, for a company that gives revenue guidance with a very narrow $4 million band, beating the high-end is a positive in our view.

- Professional Services went back to a sizeable loss again. This was a large headwind for earnings. This service is for clients that want help setting up DOCU software and training. In 3Q23's EPS of 57 cents, this was a positive swing of 2.5 cents in EPS and 100bp of operating margin. Now on the 4Q23's 65 cents, it cost DOCU 3.5-cents in EPS and 130bp of margin:

	1/31/23	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Professional Sales	$15.9	$21.4	$17.0	$19.4	$16.8	$16.9	$19.1	$17.1
non-GAAP Pro Income	($8.9)	$1.6	($5.0)	($2.5)	($9.6)	($6.3)	($2.6)	($3.2)

- Stock compensation as a percentage of sales rose in 4Q. This removed more cost from the adjusted earnings. We consider this a negative as the ratio should be 20% vs. the 22.4% it just posted which added 2.8 cents to EPS.

	1/31/23	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Sales	$659.6	$645.5	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1
Stock Comp	$145.9	$135.2	$141.2	$110.7	$118.0	$109.4	$100.0	$81.1
Taxes on Exercise	$1.9	$2.5	$3.4	$5.1	$4.2	$10.1	$11.6	$16.3
Total	$147.9	$137.7	$144.6	$115.8	$122.2	$119.5	$111.5	$97.4
% of Sales	22.4%	21.3%	23.2%	19.7%	21.0%	21.9%	21.8%	20.8%
Stock Comp %	22.1%	20.9%	22.7%	18.8%	20.3%	20.1%	19.5%	17.3%

On earnings overall – we consider the beat real. A 13-cent beat with the professional sales loss of 3.5 cents more than offsets the earnings gains from a low forecasted margin and seeing the stock compensation percentage increase.

The market was strongly disappointed in guidance for billings coming in at 2% for 1Q24 and even forecasting a back-loaded year with billings at only up 2.5% for fiscal 2024. For a software company, that's a serious red flag. Billings become future revenues so slower billings should mean slower revenue gains.

- Billings and near-term revenue is still being hurt by real estate-related transactions that were early adopters of DOCU software. Fewer people are buying/selling/refinancing homes right now.
- DOCU is making forecasts off what it is currently seeing in results, not trying to predict what could change – so the billing forecast is likely very conservative.
- What caught our eye is some of the key metrics turned up in the last quarter:

	1/31/23	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Rentention	107%	108%	110%	114%	119%	121%	124%	125%
Billings/Revenue	112%	102%	104%	104%	115%	104%	116%	112%
Deferred Rev DSOs	166	157	162	162	166	162	169	163

  - Retention still declined but is still above 100% and the rate of decline slowed. As that measures dollars spent by the same clients y/y, it is still getting growth from the existing base.
  - Billings/Revenue fell to 102%-104% since DOCU began reorganizing and training its sales force – It just returned to 112%. There are signs in the earnings slides that this indicates that larger customers are buying more.
  - Deferred revenue (contract liabilities) had been slipping for several quarters. That is what becomes future revenue and it bounced up 9 days in 4Q23.

DOCU also announced it would reduce headcount by another 10% and will reinvest some of that savings into more R&D and tie-ins with other software services. That cut will happen largely in 1Q24 (April) and even reinvesting some savings in R&D, the adjusted operating margin forecast of 21%-23% for fiscal 2024 looks low to us. They are already above the high end of that range now before the 10% cut in the workforce. It sounds like the newly-trained sales force is ready to give demonstrations, training, and installations of the software. That could enable

DOCU to cut the loss in professional sales – and that alone was a 130bp negative swing in margin in 4Q23.

Medtronic (MDT)
Earnings Quality Update

We are downgrading our earnings quality rating on MDT to 3- (Minor Concern) from 4+ (Acceptable)

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

Summary

MDT beat the consensus estimate by 3 cps in 4Q22 and topped revenue goals by $200 million. Growth in non-GAAP "non-operating income" added 4.3 cps to EPS in the period. This account includes interest income which the company admitted was one of the drivers of earnings coming in 3 cps ahead of its forecast. However, management also implied on the call that FX was a 3 cps larger than expected headwind which balances out the boost from higher interest income.

We consider MDT's earnings quality to be one of the stronger ones in the med-tech companies we follow. Clients can review our earnings quality comparison of five med-tech companies here.

However, given an unusual movement in prepaid expenses and the continued increase in receivables, we are reducing our earnings quality rating to Minor Concern.

- **Other accrued expenses showed an unusual $400 million decline in the 1/23 quarter**. The portions of the account disclosed in the footnotes actually increased and management's explanation for drivers of the account does not fully address the decline in accrued expenses. Accruals in July were already high and rose another $200 million in October. So, the $400 million decline in January may be magnified by compensating for that increase. Also, the $400 million decline was buffered by a $100 million increase in FX contracts. Every $100 million drop in expenses is worth 6 cps. A case can be made that the drop in accrued expenses added more than 24 cps to earnings in a quarter where MDT beat by 3 cps.

- **Receivable DSOs jumped to 69.3 days from 67.5 days in the previous quarter and 63.8 days in the year-ago quarter.** The absolute level of receivables is not overly alarming compared to the pre-Covid range in the high 60s to low 70s. However, management noted in the 10-K that receivables were impacted by the "timing of sales,

slower collections, and supply chain challenges as compared to the corresponding period in the prior fiscal year." We note that several of the company's peers saw similar moves in receivables in the latest quarter and SYK also specifically noted that it benefitted from orders received late in the quarter. This reduces our level of concern although we note that this is the second straight quarter management has given this explanation for higher receivables and this should be watched closely in the next quarter. ***(See below for detail)***

- **Inventory DSIs fell to 185.9 days in the fourth quarter from 187.5 in the previous quarter**. However, they remain elevated versus 170.1 in the year-ago period and their 150-160 day pre-Covid range. We do not see any unexpected surprise hidden in inventory given that management has talked openly about inflation driving up inventories and how that will negatively impact the income statement into 2023. However, analysts should be looking for inventory DSIs to continue to show a downward trend into the next couple of quarters. ***(See below for detail)***

- The company continues to stand by its prediction that the current Enterprise Excellence and Simplification restructuring programs will both wind down by the end of the current fiscal year. It has also not expanded the expected cost or completion date in the last year which is encouraging. While the MDT's restructuring charges have not amounted to as large a percentage of non-GAAP profits as some others in the med-tech group, we note that over 65% of the charges in the last nine months were in "associated costs" which includes "salaries for employees supporting the program and consulting expenses." The subjectivity involved in deciding what percentage of an employee's time should be considered non-operating and ignored when calculating non-GAAP profits erodes the quality of those adjusted results. Analysts should be skeptical if the company extends the scope of the program before the end of the fiscal year. ***(See below for detail)***

- MDT disclosed in the 10-K that it received a verdict against it in the Colibri Heart Valve patent infringement case in the amount of $106 million. The company is appealing the case and indicated it is confident it will win. Note that MDT has not reserved for the loss leaving open a potential 6 cps charge should the appeal not go as the company hopes.

Other Accrued Expense Decline

We noticed an unusual decline in the "other accrued expense" liability on the balance sheet. The following table shows other accrued expenses on a days of sales basis for the last sixteen quarters:

	1/27/2023	10/28/2022	7/29/2022	4/29/2022
Other Accrued Expenses	$3,630	$4,031	$3,816	$3,551
Other Accrued Expenses Days	42.8	48.4	47.1	39.9

	1/28/2022	10/29/2021	7/30/2021	4/30/2021
Other Accrued Expenses	$3,542	$3,469	$3,652	$3,475
Other Accrued Expenses Days	41.5	40.2	41.6	38.6

	1/29/2021	10/30/2020	7/31/2020	4/24/2020
Other Accrued Expenses	$3,999	$3,589	$3,338	$2,993
Other Accrued Expenses Days	46.8	42.7	50.3	45.4

	1/24/2020	10/25/2019	7/26/2019	4/26/2019
Other Accrued Expenses	$3,580	$3,115	$3,147	$2,925
Other Accrued Expenses Days	42.2	36.8	38.2	32.7

Points to note:

- Other accrued expenses increased noticeably in the 7/22 and 10/22 quarters on both an absolute and days of sales basis before falling sharply in the 1/23 quarter. While Covid has blurred typical seasonal patterns, neither the last two years nor the pre-Covid 2020 period show a similar pattern of a fall off in accrued expenses in the fourth quarter.

- Using footnote information, we can identify several components which comprise about half the account. The following table shows their movement over the last three quarters:

Identified amounts in accrued expenses	1/27/2023	10/28/2022	7/29/2022
Rebates	$1,100	$1,000	$955
Deferred Revenue	$311	$293	$302
Fair Value of Contingent Consideration	$137	$149	$64
Total Liabilities Held for Sale	$41	$30	$38
MCS-related Obligations	$84	$83	$81
Currency FX Contracts- Designated	$107	$5	$24
Currency FX Contracts- Non-Designated	$15	$23	$20
Total Return Swaps	$0	$14	$9
Total Known Accrued Expense Items	$1,795	$1,597	$1,493

- The table shows that the known components of other accrued expenses *increased* over the last three months. We asked the company about the reasons for the decline in the other accrued expenses account and they indicated that the biggest driver of the quarterly movements in the account were changes in the cash collateral positions in foreign exchange derivative contracts. MDT discloses the carrying value of its currency FX contracts in the footnotes which are included in the above table. We see above that movement in those amounts were the main driver of the *increase* in the known amounts. This leaves the source of the decline in the total other accrued expense account unexplained.

- The unexplained increase in accrued expenses in the July and October quarters signals an increase in expense recognition followed by a slowdown in expense accruals to the benefit of the January quarter. We are concerned that this decline in expenses may not be sustainable. For reference, $100 million in expenses amounts to roughly 6 cps in earnings.

Receivable DSOs Rose and Company Noted Timing and Slower Collections

The following table shows DSOs for the last sixteen quarters:

DSO	1/27/2023	10/28/2022	7/29/2022	4/29/2022
Revenue	$7,727	$7,585	$7,371	$8,089
Trade Receivables	$5,887.0	$5,626.0	$5,308.0	$5,551.0
DSO	69.3	67.5	65.5	62.4

	1/28/2022	10/29/2021	7/30/2021	4/30/2021
Revenue	$7,763	$7,847	$7,987	$8,188
Trade Receivables	$5,446.0	$5,493.0	$5,431.0	$5,462.0
DSO	63.8	63.7	61.9	60.7

	1/29/2021	10/30/2020	7/31/2020	4/24/2020
Revenue	$7,775	$7,647	$6,507	$5,997
Trade Receivables	$5,215.0	$5,348.0	$4,876.0	$4,645.0
DSO	61.0	63.6	73.4	70.5

	1/24/2020	10/25/2019	7/26/2019	4/26/2019
Revenue	$7,717	$7,706	$7,493	$8,146
Trade Receivables	$6,248.0	$6,118.0	$5,894.0	$6,222.0
DSO	73.7	72.2	71.6	69.5

Points to note:

- Receivable DSOs jumped to 69.3 days from 67.5 days in the previous quarter and 63.8 days in the year-ago quarter. The absolute level of receivables is not overly alarming compared to the pre-Covid range in the high 60s to low 70s.

- However, management noted in the 10-K that receivables were impacted by the "timing of sales, slower collections, and supply chain challenges as compared to the corresponding period in the prior fiscal year." Several of the company's peers saw similar moves in receivables in the latest quarter and SYK also specifically noted that it benefitted from orders received late in the quarter. This reduces our level of concern although we note that this is the second straight quarter management has given this explanation for higher receivables and this should be watched closely in the next quarter.

Inventory DSIs Rose

The following table shows DSIs for the last sixteen quarters:

	1/27/2023	10/28/2022	7/29/2022	4/29/2022
Total Inventory	$5,375	$5,055	$4,809	$4,616
Non-GAAP COGS	$2,631	$2,453	$2,467	$2,543
DSI	185.9	187.5	177.4	165.2

	1/28/2022	10/29/2021	7/30/2021	4/30/2021
Total Inventory	$4,514	$4,349	$4,288	$4,313
Non-GAAP COGS	$2,415.0	$2,446.0	$2,549.0	$2,601.0
DSI	170.1	161.8	153.1	150.9

	1/29/2021	10/30/2020	7/31/2020	4/24/2020
Total Inventory	$4,508	$4,484	$4,551	$4,229
Non-GAAP COGS	$2,569.0	$2,660.0	$2,466.0	$2,217.0
DSI	159.7	153.4	180.9	173.6

	1/24/2020	10/25/2019	7/26/2019	4/26/2019
Total Inventory	$4,122	$4,042	$3,932	$3,753
Non-GAAP COGS	$2,342.0	$2,358.0	$2,328.0	$2,448.0
DSI	160.2	156.0	153.7	139.5

Points to note:

- Inventory DSIs fell to 185.9 days in the fourth quarter from 187.5 in the previous quarter. However, they remain elevated versus 170.1 in the year-ago period and their 150-160 day pre-Covid range.

- Management has talked openly about inflation driving up inventories which will be negatively impacting the income statement into next year. Analysts should be looking for inventory DSIs to continue to show a downward trend into the next couple of quarters.

Philip Morris International Inc. (PM)
Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are reinitiating earnings quality coverage of PM with a 4- (Acceptable) rating.

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

Summary

Philip Morris (PM) does not have a history of making many acquisitions. Its focus was on expanding its market share in international markets and then on rolling out heated tobacco with its IQOS devices and other non-cigarette products. PM bought a larger stake in tobacco businesses in Mexico and Pakistan in 2007 and Rothman's in Canada in 2008. PM did not make a significant deal again until 2021 and 2022.

We like the latest deals very much because they address one of the biggest problems PM always has to deal with – It has sizeable annual outflows in US dollars yet it did not sell anything that produced dollars.

We also believe that getting out of the Altria (MO) partnership on heated tobacco and IQOS for the US will ultimately enable PM to roll out much faster.

Our rating of 4- reflects that hurdles remain in the next two years and the debt figure may remain higher than normal for several years. Additionally, we believe the company's acquisition accounting is aggressive although not out-of-line with many of its peers.Plus, this is still a tobacco company with litigation and governments changing rules. Russia is a material part of PM's current business at 7% of sales and conceivably could see more of those sales lost or increasingly hampered.

What to Watch

- The accounting for the Swedish Match deal is aggressive in our view. PM's income statement will show virtually no cost for a $14.5 billion purchase. $13.3 billion was assigned to goodwill and won't be expensed. $2.1 billion will be assigned to indefinite-lived intangibles and won't be expensed. $2.4 billion will be amortized over 10 years or 20 years, but PM now adds that back to adjusted EPS. Marking up inventory will also impact margins for 4Q22 and 1Q23. ***(See below for detail)***

- **PM changed the definition for adjusted earnings in 2Q22 to add back acquired intangible amortization.** We consider other items in adjusted earnings to be recurring items as well that should be quantified, but not considered one-time events and may consume cash such as reducing the cigarette manufacturing footprint. In the big picture, the earnings quality impact of PM's non-GAAP adjustments are smaller overall than many other companies we follow. Our biggest concerns related to FX and amortization of the Swedish Match deal. ***(See below for detail)***

- **PM has $9+ billion in annual dividends and interest expense paid in US Dollars. Free Cash Flow was only about $10 billion, all of it in foreign currencies.** Building a US business that does not cannibalize existing PM business should help mitigate this continual exchange of currencies. ***(See below for detail)***

- Hedging FX is a major part of PM's operating model because it needs dollars. It is rare that FX is not a headwind overall for PM and the hedging activities are not free. **We believe hedging expenses are a 10-20 cent hit to EPS.** On the plus side for earnings quality, PM does not add these costs back. ***(See below for detail)***

- **Entering the US market with Swedish Match and no longer splitting IQOS in the US with Altria (MO) should help mitigate the FX issues that PM faces.** There are positives and negatives of these deals – overall we view this as favorable for PM. But, we expect dollar needs to grow initially and debt should stay elevated for at least two years. ***(See below for detail)***

- **Among the positives – PM does not need to defend a US-based cigarette business as its former partner MO did which will speed up the rollout. PM sees the US profit**

pool at $20 billion and it aims to get 10% of that within 6 years. Swedish Match provides some initial infrastructure. ***(See below for detail)***

- **Issues with heated tobacco still require heavy investment** and potential legal issues to resolve. However, the prior JV with Altria was moving slowly. If this goes as planned now, PM should be able to roll out much more quickly. This could be a huge positive for PM and an ugly outcome for MO. ***(See below for detail)***

- **Russian wild card –** We don't have any additional insight into the war between Russia and Ukraine. PM has a manufacturing plant in Ukraine that is currently closed and $414 million in assets. Ukraine was 1% of revenues last year. Russia was 7% of revenues and there are $2.5 billion in assets there for PM. It has stopped new investment there and new product roll-out. There is a risk of western governments demanding companies divest there or pay penalties for selling to Russia. There is a risk that fixed assets get destroyed and that assets are seized/nationalized. A write-off in this area would not surprise us.

Swedish Match Deal Accounting Is Aggressive

We like the rationale behind the purchase: The company is growing at double-digit rates, it is in PM's area of expertise, it opens an important new market in the US, and it produces a large amount of its cash flow in US dollars.

The deal cost $14.5 billion in cash - so this wasn't free. PM has the experience and the ability to build something like this from scratch. Had the company pursued that route, it would have taken longer, and the cost of building the business would have been expensed as wages, as capital spending became depreciation, and as R&D expenses.

But looking at the allocation of the $14.5 billion, there is not much in the way of expensing:

Swedish Match	Value	Expense
Goodwill	$13,301	$0.0
Trademarks no Amrt	$2,077	$0.0
Trademarks 20-year Amrt	$904	$45.2
Dev. Tech 10-year Amrt	$367	$36.7
Customer Rel. 10-year Amrt	$1,164	$116.4
PP&E	$667	$55.6

Of the $14.5 billion purchase, only $3.1 billion will ever be expensed at all. And, from an adjusted EPS standpoint, PM now adds back the amortization of acquired intangibles. The only cost to making a $14.5 billion deal will be $50-$60 million in depreciation (ignored in an EBITDA equation) and interest on the debt (also ignored in an EBITDA equation).

We believe this creates a situation where earnings are much higher by acquiring a business rather than building it. If it took 10 years to reach the same stage by building – the bulk of the $14.5 billion would have been expensed and may have incurred interest expense too. The expenses would be much higher than $50-$60 million per year under the acquisition. That is all allowed by GAAP and there are no Goodwill Cops. PM is not the only company doing this. We're just putting this in perspective of a $14.5 billion outflow to buy $1 billion in EBITDA and there is essentially zero expense to it. We have seen other companies assign more to intangibles and not exclude amortization.

Going forward, PM has plans to expand the Swedish Match operations and roll its products out to new markets. PM is already guiding to higher capital spending and more investment in products, marketing, and distribution. Thus, future investments will be expensed and hopefully, new revenues cover that. Also, incremental costs may be much lower than building in cases where Swedish Match is introducing products into markets where PM already has distribution. If Swedish Match allows PM to grab 10% of the US cigarette market by 2030, worth $2 billion in profits (those are PM forecasts from earnings calls) – then it may achieve more of a 60%-40% balance between what is not being expensed and what is. PM specifically notes that the goodwill value primarily reflects future US growth opportunities and US synergies.

Also in the allocation, PM marked up the value of inventory at Swedish Match by $146 million. This was done to reflect fair market value. That effectively boosts cost of goods sold and impacts profits. PM recorded $125 million in 4Q22 and will see the remaining $21 million in 1Q23. That was about 6 cents of GAAP EPS headwind in 4Q22 and should be 1 cent for 1Q23.

Adjusted EPS Has Some Recurring Cost We Would Leave In

We do not have a problem when a company adjusts for truly one-time items that are unexpected. PM has had several of these in recent years:

- The Trump tax cuts in 2017 that also impacted repatriated foreign earnings
- Deconsolidating its Canadian operation after a tort ruling put it in bankruptcy in 2019
- Countries changing tax/customs issues – Russia, Brazil, Saudi Arabia.
- The Russian/Ukraine war disrupting sales in 2022

Where we have a problem with non-GAAP adjustments is when a company excludes routine costs that everyone knows are coming. Many are a part of the business model by design. In PM's defense, we have seen companies that add back items like stock compensation and pension expense and even taxes to adjusted earnings. PM is not doing that.

There are also companies that grow through acquisition but add back the transaction costs and integration costs of each deal. If the company makes many deals every year then these are ongoing expenses in our view. Because PM is not a heavy deal maker, we would consider the transaction costs associated with Swedish Match to actually be one-time in nature.

However, we will call out PM on adjusted earnings in four places:

- Amortization of acquired intangibles – We noted above that only about 17% of the total purchase price of Swedish Match is being expensed on GAAP purposes. PM changed its definition of adjusted earnings in 2022 to add back even this modest amortization to adjusted earnings. We can easily see that this expense will last 10-20 years. This is not a one-time item in our view and is a large cash outlay.
- Optimizing the footprint – It is not a surprise to anyone that smoking levels are declining and PM's primary goal is to manage that decline and offer new products to replace it. That is the operating model. It has a goal of reducing costs by $2 billion through 2023 by closing surplus cigarette capacity – and is achieving this thus far. There are parts to this that may be considered one-time such as signing a new distribution contract in South

Korea in 2021. But, an orderly reduction in cigarette production is a known event and consumes cash in many areas.

- Changes in the valuation of equity security investments – GAAP added this in 2019. And starting then, PM adjusted it out. This is still very minor and moves with FX and income/losses. FX seldom is a positive for PM.

- Currency losses on FX translation – PM reports its adjusted EPS both before and after FX issues. PM does business in many emerging markets and some have hyperinflation. This is a lumpy item, but it's not only recurring – it's almost always a loss. In the last 10 years, PM had a small FX translation gain in 2021 after a horrible 2020 and followed it with a horrible 2022. We think this is a real cost.

If we look at the last five years, we would consider a more accurate adjusted EPS to be as follows. Note that we allowed the add-back for the transaction costs of Swedish Match and the Inventory Step-Up to remain out of adjusted EPS. Because this company does not make many deals, we can see those as one-time items. We also added back the changes made to the new distribution contract in South Korea:

	2022	**2021**	**2020**	**2019**	**2018**
Reported Adj. EPS no FX	$6.75	$5.96	$5.49	$5.32	$5.21
FX Impact on Adj EPS	-$0.77	$0.12	-$0.32	-$0.13	-$0.11
FMV of Eq Investments	$0.02	$0.00	-$0.04	$0.02	$0.00
Optimization	$0.00	-$0.09	-$0.08	-$0.23	$0.00
Amortization	-$0.15	$0.00	$0.00	$0.00	$0.00
BTN Adj EPS	$5.85	$5.99	$5.05	$4.98	$5.10

Our basic conclusion is that earnings quality here is acceptable. PM is not crossing between losses and income as a result of adjustments. And, as we noted, there are recurring items that more aggressive companies add back but PM does not. The biggest adjustments are FX and adding back amortization of acquired intangibles. People will debate amortization as a non-cash item and that it should be ignored. We always counter that spending $14.5 billion was a cash item.

FX Is a Way of Life for PM – What Are Its Dollar Needs?

Because PM is a US-based company and reports its results in USD, we do not think people fully appreciate how much FX dominates this company's operations. From the 10-K, PM gives these warnings:

> *"Because we are a U.S. holding company,* ***our most significant source of funds is distributions from our non-U.S. subsidiaries****.* ***Certain countries in which we operate have adopted or could institute currency exchange controls and other regulations that limit or prohibit our local subsidiaries' ability to convert local currency into U.S. dollars*** *or to make payments outside the country. This could subject us to the risks of local currency devaluation and business disruption."*
>
> ***"We conduct our business primarily in local currency and, for purposes of financial reporting, the local currency results are translated into U.S. dollars based on average exchange rates prevailing during a reporting period.*** *Foreign currencies may fluctuate significantly against the U.S. dollar reducing our net revenues, operating income and EPS.* ***Our primary local currency cost bases may be different from our primary currency revenue markets****, and U.S. dollar fluctuations against various currencies may have disproportionate negative impact on net revenues as compared to our gross profit and operating income margins."*

First, consider what cash outlays and liabilities are in US Dollars:

- $28.05 billion in long-term debt is US Dollar denominated
- Only 7% of the Pension obligation – about $600 million, which is funded
- $7.9 billion for the $1.27 quarterly stock dividend
- $1.16 billion for the interest on US bonds
- $100-$200 million in US taxes

How about earnings and cash flow – these are GAAP:

	2022	2021	2020	2019	2018
Net Income	$9,527	$9,710	$8,592	$7,728	$8,286
Cash from Ops	$10,803	$11,967	$9,812	$10,090	$9,478
Capital Spending	$1,077	$748	$602	$852	$1,436
Free Cash Flow	$9,726	$11,219	$9,210	$9,238	$8,042
Dividend	$7,812	$7,580	$7,364	$7,161	$6,885
Share Repurchases	$209	$775	$0	$0	$0

The dividend is routinely about 80% of free cash flow and about 80% of net income. That is high, but as a cash cow business, PM has shown it can cover this.

PM could continue to borrow some money in dollars if necessary to cover a shortfall in any given year. Total debt at the end of 2022 was $43.1 billion and there was $3.2 billion in cash. With adjusted EBITDA of $13.8 billion, the ratio is 2.9x.

PM cannot do this forever and debt is up from 1.6x at the end of 2021. That surge in debt is due to the purchase of Swedish Match near the end of 2022 – so PM only had a few weeks of that company's annualized $1 billion in EBITDA in 2022. It also includes the first $1 billion paid to Altria. The ratio is likely closer to 2.7x and PM promised that it intends to pay down debt going forward. Swedish Match gets two-thirds of its sales in the US market. This is a good start toward generating $600 million of US dollars in EBITDA.

We will discuss this more below, but taking over 100% of rolling out heated tobacco in the US, PM will need to build manufacturing and distribution in the US. This will be a future outflow of dollars too – perhaps another $1 billion was speculated about on the earnings call.

How Much does PM Spend Managing FX?

PM is very clear when it reports earnings how much currency exchange can help/hurt results. More often currency is a sizable headwind for PM. In the last 10 years, PM had one year of positive FX impacts and that was modest sandwiched between two years of steep headwinds. These are the results it reports and the currency impacts when it translates results to US Dollars:

FX Impact	2022	2021	2020	2019	2018
GAAP Revenue	$31,762	$31,405	$28,694	$29,805	$29,625
FX impact on Rev.	-$2,656	$268	-$469	-$937	-$454
GAAP Op. Income	$12,246	$12,975	$11,668	$10,531	$11,377
FX impact on Op. In.	-$1,507	$678	-$475	-$292	-$214
Adjusted EPS	$5.34	$5.53	$5.16	$4.61	$5.08
FX Impact on EPS	-$0.77	$0.12	-$0.32	-$0.13	-$0.11
GAAP Cash frm Ops	$10,803	$11,967	$9,812	$10,090	$9,478
FX Impact on CFO	-$1,524	$799	-$399	-$972	-$223

The -$399 million FX headwind for 2020 cash from operations only represents the first 9-months of the year. We could not find the full-year figure.

This is just the translation headwind that everyone sees. It is rare that it is a positive for PM. There are several large emerging markets among its bigger customers such as Indonesia, Turkey, Philippines. **Not only is cash flow routinely 4%-10% lower due to FX headwinds, this is also costing PM a significant amount of its EPS.** PM reports adjusted EPS with and without currency impacts. We do not mind that they quantify the size of the headwind, but there is not much evidence that this helps earnings very often. Normally, we view this as quantifying the size of the loss. We would view true earnings as including FX.

PM has FX hedges in place at both the parent level and the operating company level. It notes that much of the gains/losses it shows on hedging are partially offset by the hedges at the foreign operating company level. It forward sells some currency too. PM also sells about $12 billion in receivables per year. We believe this program brings cash into PM faster, but it may also convert the currency faster too. That should limit FX damage if a receivable is only held for a few days vs 30-60 days. **We don't have a problem with PM's program of dealing with this inherent operating issue. We will simply point out that there are still areas of this beyond PM's control. And, it is dependent on converting at least 80% of its cash flow into dollars, but they routinely lose 4%-10% of cash flow in this area.**

All this hedging is not free. Some hedges tie up cash. With interest rates increasing, that costs PM some income. PM has tens of billions in total exposure to FX instruments. Some of these arrangements require premiums to be paid. PM lists the cost of FX transaction gains/losses too. Every $20 million is about 1 cent in EPS. We also see that selling the receivables has a rising cost now that rates are turning up. It was $9 million in 2020 and $26 million in 2022 on almost the same volume of sales.

	2022	2021	2020	2019	2018
Hedging Trans (L)/G	-$199	-$45	-$90	$95	-$21
FX contract (L)/G	-$169	$215	-$368	-$115	$378

Even ignoring the cash tie-up and lost interest income, selling receivables in 2022 cost PM 1 cent in EPS, and hedging transactions and FX contract losses cost them another 19 cents. The **repatriation of foreign dividends is then about 0.6%-0.7% of the tax rate PM is paying. In 2022, that was $77 million or 5 cents in EPS**. All that is on top of the translation losses PM calls out to show results on a currency-neutral basis.

To be clear, PM is still going to have a huge foreign operation even after it enters the US market with heated tobacco. Thus, hedging is not going to vanish as a key aspect of PM's business model. However, rolling out more products in the US may start to directly generate some dollars to fulfill PM's dollar needs without FX issues. PM may be able to scale down some of the hedging operations and simply maintain more Euros and other local currencies. This may reduce costs and potential losses.

What Is the Potential for PM's US Market Plan?

The long-term goal for all the tobacco companies has been to keep customers while switching them away from traditional cigarettes. They all talk about vapor, snuff, dissolving oral tablets, and heated tobacco. Both Swedish Match and heated tobacco bring these non-cigarette products and in the cash of Swedish Match, it is already operating in the US for about two-thirds of its sales. It is also posting double-digit growth on a low base.

However, cigarettes are more profitable. Much advertising is banned, the distribution is entrenched, the factories and machinery already exist to meet full demand, stores and customers don't need education, and little R&D is spent. Thus, companies want to limit the volume decay in cigarettes, reduce capacity to cut costs, and boost prices to offset volume losses. Even PM comments about this. Cigarettes are a huge cash cow, but they want to manage the decline by putting people into other nicotine products.

Here are the impacts of heated tobacco entering some markets around the world:

Markets by Vol.	2022	2021	2020	2019	2018	2017	2016
Japan total	137.3	139.5	142.9	157.8	167.3	171.5	179.0
PM Heated	34.4	33.1	28.9	25.8	21.4	31.3	7.1
PM Cigarettes	21.1	22.1	22.2	26.6	30.8	34.9	43.9
Italy total	72.8	70.4	67.4	67.9	69.0	69.8	72.1
PM Heated	12.3	8.9	5.6	3.5	1.7	0.7	0.1
PM Cigarettes	28.6	29.7	29.0	31.4	33.5	36.1	38.6
S. Korea total	72.6	71.7	71.6	68.6	69.5	70.6	73.6
PM Heated	4.5	4.7	4.6	4.6	5.4	1.4	0.0
PM Cigarettes	9.4	9.4	10.2	10.8	12.0	13.5	15.5
France total	32.5	34.3	36.6	37.9	40.9	45.9	44.9
PM Heated	0.2	0.2	0.2	0.1	0.0	0.0	0.0
PM Cigarettes	13.7	15.0	16.1	16.9	18.4	19.7	19.2

- These are billions of units
- In 2022, Japan started adding Cigarellos to the total volume. We know the difference with and without that in 2021 was 11 million units, we removed the same 11 million units for 2022.

Japan was one of the first markets to allow heated tobacco and there were three entrants including PM. Early on, the market was hurt by demand exceeding supply and then people trying it briefly and stopping. But we think the trends are clear:

- Total cigarettes and heated tobacco sticks are down 23% since the introduction of heated tobacco.
- PM was selling 51 million units of both in 2016 and now sells 55.5 million – so it gained share in a shrinking market.
- Its cigarette volumes collapsed by 52% in 6 years.

Italy was another early market for heated tobacco. It started more slowly in just a few cities. It is interesting to note that Italy has not seen an overall decline in the total smoking and heated volume. It remains at 72-73 billion units. However, even this market showed a big drop in cigarette volumes:

- PM's volume of cigarettes dropped from just under 40 billion units to 28.6 billion – a drop of 26%.

- But, heated volumes added 12.3 billion back – total PM volumes are almost flat.

- South Korea shows the same results.

France is a market where PM has been slow to roll out heated tobacco. There are some competitors there and there have been issues at times with the government:

- The total market is down 28% since 2016.

- PM has seen its cigarette volumes fall 29% with almost no replacement impact from its small heated tobacco market share.

There are several advantages to for PM to go it alone in the US market vs. the partnership with Altria when it comes to heated tobacco:

- It looks like PM will be the first to market. It is planning to be rolling out IQOS and heated tobacco in the 1H24. MO has a new JV with Japan Tobacco for a competing product. But, it does not plan to even file for approval until 1H25. PM could be in the market for well over a year before MO.

- PM will get 100% of the revenues and profits rather than splitting them with MO.

- The partnership roll-out was not blazing in our view. In September 2019, MO rolled out IQOS and heated tobacco in some stores in Atlanta, GA. Richmond, VA saw an introduction in November 2019. Charlotte, NC came in July of 2020. By 2Q20, MO was only selling the product in 700 stores. By 1Q21, they announced they had achieved 1.1% of the cigarette market in Atlanta and 1.0% in Charlotte. New expansion plans were halted in 2Q21 with Reynolds' patent lawsuit.

- We believe MO had a conflict in doing a faster roll-out. PM already had years of experience in rolling out heated tobacco in several markets around the world. One of the nuggets of knowledge PM talks about it in its 10-K reports is "*only a very small percentage*

of adult smokers who convert to our Platform 1 [IQOS] product switch back to cigarettes." But, MO was earning 100% of the profits on the sale of all other tobacco products it sold in the US. Unless they could convince customers to use existing tobacco products at the same rate AND start using heated tobacco too – every heated tobacco sale would cannibalize MO's sales and only give it a portion of the new sale.

- Now, PM does not have to worry about protecting an existing cigarette market when it rolls out heated tobacco again. PM can go full steam ahead in many markets at the same time and every sale it makes is 100% incremental cash flow in dollars to itself. Taking a meaningful share of the US cigarette market is now the goal.

PM itself spelled out many of these types of advantages when discussing the $2.7 billion purchase from MO on the 3Q22 earnings call. They expect a faster roll-out in more areas. They even quantified the size of the US market. These are all quotes from PM management:

- ***"The U.S. is the world's biggest accessible nicotine market by retail value.*** *The estimated retail value of its growing smoke-free market is already around 60% of all international markets combined, excluding China."*

- *"Importantly, the return on investment for IQOS in the highly profitable U.S. tobacco market is compelling.* ***We estimate the total U.S. industry profit pool at over $20 billion****, and with average unit margins on U.S. cigarettes more than 3 times greater than for the PMI average, the payback over the next few years on the consideration paid to Altria looks very attractive."*

- *"The true potential for IQOS in the U.S. is substantial, as illustrated by the double-digit national shares achieved in just a few years across a number of Asian, European, and other markets, all with varying demographic profiles and adult smoker taste preferences.* ***We believe a volume share of 10% of cigarettes and HTUs by 2030 is very achievable, with potential to go much further."***

- *"****We are ready to invest behind IQOS to bring it to market at scale across the U.S., starting with full-scale launches in key cities and regions, with a plan to progress rapidly to national penetration."***

- *"As we do not have a legacy cigarette business in the U.S., the opportunity is purely incremental."*

- On the 4Q22 call, PM noted again the IQOS conversation rate, *"And* ***how many people fully adopt the IQOS and not only that they are leaving cigarettes fully behind them, they don't***

__even attempt it on occasional basis to go back to cigarettes__, okay, so that's the core and I believe for the audience which with the smoking audience, which you have in the U.S."

Potential Hurdle Remain for PM's IQOS System in the US

The original plan with the PM/MO joint venture was to import the IQOS products from PM's existing infrastructure and have MO do the distribution with its existing infrastructure in the US. Reynolds of BAT sued PM over patents on IQOS in both Federal Court and the ITC (International Trade Commission).

- In Federal court – BAT sued PM for patent infringement and PM countersued. The jury sided with PM and awarded PM damages from BAT. It also concluded that BAT did not infringe one of PM's patents and BAT failed to prove that one of PM's patents was invalid.

- The ITC initially ruled that PM violated two of BAT's patents, it later ruled saying PM was violating the US Tariff Act. Its order was that PM could no longer import its IQOS device and that MO could no longer distribute PM's imported device.

There are still appeals on these cases ongoing. PM doesn't expect to reverse the ITC issues. Where this stands now has several differences:

- The ITC case impacts importing the IQOS device and using MO as a distributor of the imported device – Neither situation is in the plans now. PM plans to make the product in the US and MO is not part of the equation going forward.

- The ITC case also involves PM's Platform 1 product. PM is not planning to use that IQOS device in the US and will instead use the newer IQOS ILUMA design which is a different platform.

- The Federal court did not recognize the patent that BAT is claiming as valid. It actually sided with PM and found BAT in violation of some PM patents.

- PM already had its PMTA (PreMarketing Tobacco Product Application) approved by the FDA for the IQOS 2.4 and IQOS 3 for sale in the US. It will file its PMTA for the IQOS ILUMA in 2H23.

- PM will need to build out its domestic manufacturing and will also need to build out the distribution infrastructure. On the 2Q22 conference call, PM highlighted the Swedish Match acquisition as a key part of this:

  "Another competing rationale for this deal is a large, attractive and growing U.S. smoke-free market. ***Swedish Match as the leading nicotine pouch franchise, with ZYN, and a substantial U.S. operational platform, which would help us unlock the significant opportunity across other more categories over the coming years.*** *This would be a strong strategic and cultural fit, offering significant shareholder value creation over the medium and long term."*

  On the 4Q22 call, *"**We will be leveraging the sales and distribution capabilities of Swedish Match** and deploying our commercial model digital engine organization and infrastructure for a successful rollout.* ***We continue to expect to file an FDA application for ILUMA in the second half of 2023.***

  Logically, the international expansion of pouches, ***U.S. IQOS preparation and the replacement of IQOS 3 with ILUMA entail additional investments this year****, which combined with inflationary pressures will weigh temporarily on our margins."*

- PM expects capital spending to rise about $200 million in 2023 and SG&A costs to rise $150 million for incremental investments on future growth projects.

All this is why we said earlier that PM may be spending more heavily in 2023-25 building out its new projects in the US. Thus, while the goal is to see the debt figure start to decline, there is some additional spending that is still coming that may not be offset with new revenues for more than a year.

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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