BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

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Air Products & Chemicals (APD) Earnings Quality Update

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

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

Summary

APD's 1Q23's $2.64 in adjusted EPS missed forecasts by 6 cents despite a few unusual factors that helped EPS. The market seemed more upset over guidance of $2.50-$2.70 for 2Q23, changes in the structure of a key project, and rising interest rates. We believe the market is overreacting and the long-term growth story remains intact.

- **We believe concerns over the change in the NEOM plant deal are overdone**. While the Street is focusing on the increase in upfront costs, we believe the change in structure will result in higher ROI for APD's investment. ***(See detail below)***

- APD announced coming into the year it was going to adjust out non-service pension costs – largely actuarial charges due to rising interest rates from EPS. That added 7 cents to non-GAAP EPS but was well-known going into the quarter. **However, APD now excludes the interest cost in pension expense and only focuses on service cost. Adjusted pension expense actually fell y/y from $11 million to $6.3 million despite higher interest rates. This added 1.7 cents to non-GAAP EPS.** ***(See detail below)***

- Taxes were a 7-cent headwind rising to 19.1% from 17.0%. However, APD guided to 19%-20% so this was likely a small benefit versus analysts' models.

- **Depreciation and amortization declined y/y and sequentially, adding 4 cents to EPS. With PP&E up and all the projects coming online, this seems unlikely to last.**

- Equity affiliate income was down 14 cents on the surface, but actually up 6 cents adjusting for the 20-cent one-time benefit in 1Q22 from recognizing deferred profits on the Jazan project.

- FX was a sizable negative of 15 cents in the quarter. After being a positive for EPS in 2021, it became a sizeable headwind in 2H22 through now:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
FX Impact on Sales	-6%	-6%	-5%	-2%	-1%	2%	6%	4%	3%

Guidance of $2.50-$2.70 for 2Q23 is tied to how rapidly Chinese business picks up. APD noted a weaker-than-expected China and Europe for 1Q. However, it is seeing power prices in Europe stabilize and it has price increases in place. We would expect depreciation to rise and FX to remain a headwind.

Concerns around changes in NEOM plant structure look overblown

APD originally expected changes to the deal structure of the NEOM plant to cost $5.0 billion. Now there is news that it will cost $8.5 billion and will cut the ROI because the output will remain flat and at the same price. We believe that is an overly simplistic view. The change in cost on the original design is only $500 million due to inflation. Here is where the other $3.0 billion goes:

- NEOM will now spend $1.2 billion more to add its own power transmission and additional infrastructure to make the plant fully self-sufficient. That will lower operating costs.

- Originally, the project was going to lease the land. Now $300 million will go toward purchasing the land and locking that in at a lower cost than leasing with financing.

- Another $200 million will purchase spare/replacement parts at the same time as construction. This will reduce future maintenance costs and again lock in some of that operating cost.

- Total debt will rise from $3.3 billion to $6.2 billion on the project. That will also boost capitalized interest during construction which now comes in at $1.0 billion.

- Rather than be owned by APD for $1.7 billion in cash with $3.3 billion in debt, the project will be a stand-alone JV with more debt to boost ROE. APD will put up $800 million of cash and free up about $900 million that it had originally planned to spend. That money can be used elsewhere now.

The ownership of NEOM will show up in APD's equity affiliates income at a smaller ownership stake. The outlook for the original plan called for a 12% ROI for APD on a $1.7 billion investment. That included selling all of the output from the plant. However, under the new deal:

- APD still gets to sell 100% of the output even though it will own 35% of the project and the cost it will pay for the output remains the same as before.

- APD still expects the project to generate a 10% operating margin on the sale of the output. That return will be on a 65% smaller investment, which should boost ROI.

- ROI on the equity investment will benefit from having no lease expense for the land, lower power costs, and having prepaid some maintenance – offset by higher depreciation for capitalized interest and $0.5 billion of inflation.

Change to pension disclosure

APD notified investors ahead of time that it would begin adding back non-service cost pension items to its non-GAAP earnings. The company has always been very upfront regarding its earnings and disclosures which is always a plus in our view. APD has minimal adjustments to non-GAAP EPS and generally focuses on true one-time items. Other recent adjustments include a Russian impairment, an ownership structure exchange for a JV, and relocating the headquarters.

The pension-related change adds back pension settlements and amortization of loss accruals. APD also did this in 2019 and 2018. However, this change also removes interest cost which will eliminate the impact of rising interest rates on pension expense. That does not sound like a one-time event to us. APD did not adjust that out in 2019 when interest rates were rising or in 2020 when they were falling.

Including only service cost and others, APD reported pension expense of $6.3 million in 1Q23 vs. $11.0 million in 1Q22. The decline added 1.7 cents to non-GAAP EPS in the quarter. However, if we include just the ordinary recurring parts of pension income/expense: service cost, interest cost, less expected rate of return – APD had pension expense of $9.6 million vs. income of $22.8 million in 1Q22. That would have been an 11.7-cent headwind to non-GAAP EPS.

Perrigo Company plc (PRGO)
Earnings Quality Update

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

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

Summary

Years of questionable management, excessive acquisitions, and tax/litigation overhangs finally caught up with PRGO in 2015 which marked the beginning of a long erosion in its stock price and favor on Wall Street. However, Joe Papa is long gone and this is a real business. Management's turnaround plan is worth careful, yet cautious consideration. The company earned $2.07 in 2022 (after substantial non-GAAP adjustments.) Next year's target of between $2.50 to $2.70 seems very reasonable given continued normalization in the cough/cold market, infant formula production, and integration of HRA. Getting to $4 in non-GAAP EPS by 2025 seems doable with more cost-cutting and supply chain optimization. However, investors must take into consideration the unrealistic non-GAAP adjustments made by the company when comparing to peers, and there is uncertainty with the company's longer-term growth strategy.

Recent earnings quality:

PRGO's 4Q22 non-GAAP EPS of $0.75 beat the consensus by 4 cps. However, we saw that a decline in the effective tax rate to 10% added 10 cps to earnings. PRGO gives very little in the way of guidance on tax rates and the company lumped its 4Q earnings call in with its February investor day and little attention was given to the nuts and bolts of the quarter. Given that rates were running well over 20% for the last several quarters makes us believe analysts were not expecting the 4Q rate to be that low. Keep in mind that the company lowered guidance by 25 cps at the midpoint after missing 3Q earnings targets by 11 cps.

We have long been critical of PRGO's aggressive use of non-GAAP adjustments and aggressive acquisitions as far back as the late 2000s. Now, the company has had a chance to regroup after

the exit of controversial CEO Joe Papa and has forged a new plan for growth without acquisitions. However, the non-GAAP adjustments are still a problem which prompts us to keep our 3 (Minor Concern) rating.

- **The company's long-time practice of adding back amortization of intangible assets grossly overstates non-GAAP earnings.** In 2022, PRGO reported $2.06 of non-GAAP EPS which ignores $1.87 in amortization of intangibles. This has been one of the main points against the quality of the company's non-GAAP earnings over the years. PRGO's growth has been very dependent on acquiring existing brands and new drug applications from other companies yet very little of the deal cost is ever reflected in non-GAAP earnings. The company's new strategy (and EV/EBITDA of 5.5) calls for it to lean away from acquisitions and towards focusing on organic growth and generating efficiencies. Nevertheless, the cost of past acquisitions should not be ignored. We believe investors should adjust earnings to include amortization expense, especially when comparing to peers that do not remove amortization expense. For reference, the company is selling for 14 times forward non-GAAP earnings, but this figure jumps to 52 times forward earnings with amortization expense removed.

- **The prevalence of restructuring charges further reduces non-GAAP earnings quality**. Restructuring charges above 5% of pretax earnings are a common occurrence at PRGO which increases the possibility that operating charges are being included in the amounts that are being ignored by investors.

- **In addition to amortization expense, the long string of acquisitions has led to regular, sizeable add-backs of acquisition and integration expenses and contingent consideration adjustments.** These were especially large in the last three quarters given the HRA acquisition and the Nestle infant formula plant deal. The company does not give a detailed description of the components of this category. We don't have a problem with expenses such as legal costs and paying consultants to review the deal. However, costs such as "integration initiatives" could include items that could arguably be considered operational in nature. Therefore, we will consider it a concern if these charges continue to show up despite the company essentially putting its acquisition program on hold.

- **Some intangibles are close to impairment.** PRGO noted in the 10-K that the fair value of the CSCI reporting unit exceeds the carrying value by less than 10%. The company used discount rates ranging from 10.25% and 11.00% and a perpetual growth rate

assumption of 2.5% in its testing. A 50 basis point increase in the discount rate or a 25 basis point decrease in the terminal growth rate assumptions would result in impairment. The discount rate increase in particular is not out of the question. The company also noted that fair value estimate depends on "material benefits" from the company's Supply Chain Reinvention Program, so any delay or disappointment in implementing the plan could result in impairment. Note that the company recorded $173 million in impairments related to the divested Latin America business in 2021 and almost $350 million in impairments in 2020 related to its now-divested RX business. Impairments add weight to the argument that investors should not ignore the cost of acquisitions.

- **Inventory DSIs jumped to 135.5 from 133.9 in the previous quarter and 123.6 in the year-ago quarter**. All of these periods are elevated compared to the 110-day range which was typical before Covid. The sequential increase in DSIs likely reflect both higher costs and production and supply chain issues in infant formula. We wonder if it could also relate to the company's reference to consumer sell-through exceeding its own sales in the quarter as retailers trimmed their inventories. This is consistent with what some other consumer products companies said about the fourth quarter. Investors should be watching for inventories to begin trending down next quarter.

Thoughts on guidance

PRGO's 2023 EPS guidance of $2.50-$2.70 looks achievable based largely on:

- **Revenue growth of 7%-10% in 2023 based on organic revenue growth of 3-6% should be attainable** through the recovery of the company's OTC cough/cold sales and integration of HRA and the new infant formula lines picked up in the Gateway deal.

- **A gross margin of 38% seems reasonable given the accretion of the HRA deal, cost reduction, and price increases carrying over from 2022.** The stock did react negatively after 3Q22 gross margin came in flat sequentially at 36.5%, but improvement resumed in 4Q22 as gross margin improved to 38.4%. Management noted on the investor day that much of this improvement was due to discontinuing unprofitably SKUs.

- **This guidance does not include approval of the Opill which could happen in the first half of 2023.** However, despite not being in the guidance, any delay of approval would almost certainly deal a significant blow to the stock price.

Concerns with outlook for 2024-2024 and beyond:

- **Maintaining quality organic growth of 3%+ after 2025 would be new territory for the company.** After 2025, PRGO plans for organic growth to hold at 3%. However, one of the key weaknesses we highlighted with the company during its acquisition phase was the fact that growth experienced by new products quickly turned negative and that organic sales before acquisitions was often below zero.

- **We are skeptical the company can play hardball with pricing.** One of the ways the company plans to keep organic growth and profitability high in the long run is to refuse negotiation on price and be willing to forego volume to maintain margins. This is also new territory and it remains to be seen if the company can successfully do this without sacrificing too much volume.

- **Likewise, forcing customers to accept their terms on packaging may be difficult.** The company hopes to drive margins by pushing store brand customers to forego custom packaging and pill counts. It plans to stress to customers that people buying store brands have indicated that all they care about is efficacy and price. However, as with pricing, it remains to be seen if retailers are willing to give up having it their way.

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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