BEHIND
THE NUMBERS
Quality of Earnings Analysis
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# Behind the Numbers

*Companies in this Issue*



## AT&T (T)
## Earnings Quality Update

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

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

### Summary

AT&T's non-GAAP EPS of $0.60 beat forecasts in 1Q23 by 1 cent. There were only two adjustments: adding back the DirecTV amortization, which was flat at 4 cents y/y, and 1 cent accounting for the mobility preferred shares that AT&T will settle for cash. This was also flat y/y. That means y/y non-GAAP EPS fell by 3 cents:

- Capitalized interest declined because more spectrum was put into use. We estimate this headwind at about $60 million, or 0.6 cents. AT&T didn't quantify this but said the headwind was present. With other interest increases and securitization fees – this becomes a full penny:

| **Capitalized Interest** | **4Q** | **3Q** | **2Q** | **1Q** |
|---|---|---|---|---|
| 2022 | $287 | $325 | $358 | $324 |
| 2021 | $306 | $297 | $290 | $61 |

- AT&T guided to a 5-cent headwind from a higher tax rate in 2023. It rose 90bp in 1Q23, costing EPS 0.7 cents.

- Guidance also called for higher interest rates to create a 20-cent headwind on pension income/expense. That was 3 cents in 1Q.

We would consider the 1-cent beat real and the y/y decline of 3 cents erased with the apples-to-oranges headwinds. AT&T confirmed guidance for 2023 of $2.35-$2.45. It also confirmed its free cash flow forecast to exceed $16 billion.

What seems to be clouding the view of AT&T at times is the company is accelerating the speed it completes some of its long-term plans. That can consume cash sooner but is cheaper in the long run. In the 1Q, three things stood out about cash flow. All of this was in guidance, but the y/y change still spooked the market. We take most of this as positive:

**Free Cash Flow Was Down y/y:**

| **Free Cash Flow** | **1Q23** | **1Q22** |
|---|---|---|
| Cash from Operations | $6,678 | $7,630 |
| DirecTV Distribution | $774 | $1,315 |
| Capital Spending | -$4,335 | -$4,568 |
| Vender Fin. Payments | -$2,113 | -$1,566 |
| Free Cash Flow | $1,004 | $2,811 |

- Cash from Operations fell by $952 million. Seasonal items impact this such as phones purchased for the holidays are paid for in 1Q as is annual incentive pay. The high growth resulted in a larger seasonal cash outflow in these areas compared to the year-ago period.

- AT&T also sold more phones on contract in the 1Q y/y and the related receivables resulted in a negative $784 million swing. Accounts payable and accrued expenses dropped an additional $758 million y/y too. That is incentive pay and December phones being paid for.

- Because AT&T is growing its subscriber base, its deferred customer acquisition costs have been rising and have been a negative on cash flow too. However, the guidance calls for this to level off at the current high levels and not be a drain on cash flow going forward. This was almost $1 billion of lower cash flow in 2022 and it is about to flip and become neutral or add to cash flow going forward.

| | 1Q23 | 4Q22 | 3Q22 | 2Q22 | 1Q22 |
|---|---|---|---|---|---|
| Def. Customer Acq Cost | -$22 | -$191 | -$250 | -$247 | -$259 |

- The payment from DirecTV was down and cost free cash flow $541 million. That was in the $16 billion of guidance for 2023. In fact, AT&T is expecting $1 billion less for all of 2023.

- AT&T has accelerated its capital spending – that's how it has doubled its initial estimate for 5G rollout in 2022 and reached 150 million pops and fiber rolled out faster too. Capital spending is expected to be about $24 billion in 2023, flat with 2022. That should be the high mark for spending. Some of the spending gets carried by vendors for several months to help cash flow. AT&T came into 2023 with $4.6 billion of vendor financing due this year. They just paid almost half that amount in 1Q. That hurt free cash flow by $311 million and is simply a timing issue.

- AT&T affirmed its free cash flow guidance for 2023 at $16+ billion. That would be up $2 billion from 2022. The only wild card we see to that is if customer growth is higher than forecast, that could continue some drag on cash flow via working capital growth in acquisition costs. But, overall that would be a positive too. Some capital spending reimbursement could be seen from government programs in late 2023, but that is not expected in guidance.

- Higher customer counts, higher ARPU, and reaching its total $6 billion in cost savings ahead of schedule are all helping cash flow and growth too. So, AT&T has growing free cash flow from that, plus capital spending should decline in 2024 to help it further. The dividend is $8 billion so free cash flow is double that.

**Where is the Debt Pay Down?**

- AT&T finished 1Q23 with debt of $134.7 billion which was 3.22x EBITDA. The goal is to use free cash flow after the dividend to pay down debt.

- The bulk of debt (95%) is fixed rate and the average cost is 4.1%.

- In 4Q22, AT&T was notified that its $8 billion in mobility preferred stock was being put to it. The terms allow AT&T to retire it over three years and it repurchased $2.6 billion in 4Q22. AT&T intended to retire the remaining shares in 2023 and 2024.

- There was a note in the financial and operating schedules for 1Q23 that – *"The Mobility II preferred interests were repurchased on April 5, 2023."* That should mean that AT&T spent $5.34 billion in April to retire that preferred stock.

- This makes financial sense to us. The preferred stock had a 7% dividend, which is paid after taxes. The pre-tax rate would be 9.3% vs. the 4.1% AT&T is paying on debt.

- Stockholders benefit further because AT&T does not have to pay out the preferred dividends, helping cash flow. That also boosts earnings to the common stock. Plus, the preferred shares boosted diluted shares by 378 million in 2022. Fully diluted shares should decline by about 5% after this repurchase.

- Debt repayment should resume in the second half of 2023.

# International Business Machines Corporation (IBM) Earnings Quality Update

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

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

## Summary

IBM's 1Q23 non-GAAP EPS of $1.36 beat forecasts by 12 cents. The company did not boost the guidance for $10.5 billion for free cash flow and likely reduced revenue guidance from Mid-Single-Digit to 3%-5%, with units like Red Hat seeing slower growth than forecast. It still sees a backloaded year with one-third of operating income in 1H23.

As usual, we will do IBM's update in two parts as we need the 10-Q to fully review results. We think the 12-cent beat was driven by one-time and short-lived items and IBM actually missed forecasts. We found 35-40 cents worth of tailwinds for EPS at this point. There are headwinds of about 26 cents we found so far, which leaves a net that likely exceeds the 12 cents. If IBM cut advertising again or had low warranty accruals as it did for 4Q, that would make the declared beat even more suspect.

- Depreciation and Amortization fell from $1.257 billion to $1.074 billion. Kyndryl is not an issue. We used the amortization from 4Q22 to arrive at an estimate for depreciation of only $507 million falling from $631 million. That is 11.8 cents of EPS. We know that IBM lengthened depreciation lives starting with 1Q23. That change added only 4.7 cents – **so IBM still picked up 7.1 cents from lower depreciation.** We can firm up that estimate with the 10-Q. We doubt divesting the healthcare software division had enough depreciation to materially impact that 7.1 cents.

- **IBM guided to a 1Q charge of $300 million. It only took a charge of $260 million, adding $40 million to pretax income versus guidance. This was 3.8 cents for the 1Q23.**

- **R&D dropped again in absolute dollars and as a percentage sales revenues (removing the financing and other revenues). This added 2.3-4.1 cents to 1Q23.** Why aren't wages rising? If they are, IBM is spending less on projects. Plus, IBM continues to buy other companies – aren't there some R&D departments being rolled into IBM? How can the total spending continue to decline?

- We need the 10-Q to fully evaluate SG&A, marketing, and bad debt expense, but here are some initial thoughts. Adjusted SG&A came in at $4.6 billion vs. $4.3 billion - $296 million higher. However, we know SG&A should have the $260 million one-time charge. Also, IBM called out workforce rebalancing reducing operating margin from 12.0% to 10.2% - which is about $250 million. **Adjusting for that, adjusted SG&A would have fallen by $214 million.** Just like with R&D, isn't there any wage growth with the current inflation? Aren't some of the employees at acquired companies staying? **Every $50 million of this that is not sustainable added 5 cents to EPS.**

- On the call, IBM specifically said that it is seeing wage inflation and that enables it to boost pricing. We again think the R&D and SG&A wages should be rising in dollar terms if this is the case:

  > *"In a labor-based business, we face the same inflation that the rest of the world is seeing. **Our employees are expecting higher wages. As we hire new people, they get hired in at higher wages than their similar colleagues were a year ago.** We have to get a return on that back from our clients."*

- **Other income rose to $242 million from $179 million.** We need the 10-Q to fully see what happened to this account. It is where IBM records interest income, and gains and losses on derivatives and securities. **This was a 6-cent benefit to EPS.** That assumes it was simply flat, not lower – **this may be a 10-cent benefit given guidance**. The problem is IBM guided for this income source to decline significantly in 2023 on 4Q earnings call:

  > *"With the movement of spot rates over the last 90 days, currency translation would be fairly neutral to revenue in 2023 with a headwind in the first half, flipping to a tailwind in the second. But I'll remind you that **we had over $650 million of hedging gains in 2022, which will not repeat in 2023, resulting in an impact to our profit and cash on a year-to-year basis."***

- The tax rate was 13.8%, down from 16.1% y/y. The problem is IBM guided to mid-high teens for taxes. That sounds like 16%-18% to us. That added 3.5 cents at 16% or 6.7 cents at 18%. IBM kept guidance flat for tax rate for 2023.

- Stock compensation was up $34 million, which hurt EPS by 3.2 cents.

- We have been calling out IBM's lack of workforce rebalancing expense that has been a quarterly expense for decades. Historically this is $200-$500 million per year. The abnormally low levels have been a big driver for EPS the last two years.

| **Workforce Rebalance** | **4Q** | **3Q** | **2Q** | **1Q** |
|---|---|---|---|---|
| 2022 | $4 | $13 | $28 | $5 |
| 2021 | -$60 | $0 | $107 | $94 |

The party is apparently over as IBM noted on the conference call that adjusted operating profit was 10.2% vs 10.7% in 1Q22. We need the 10-Q to completely quantify the workforce rebalancing change but can estimate it based on this comment:

> *"Operating pre-tax income, excluding the impact of workforce rebalancing, was up 12 percent and margin expanded 130 basis points."*

Using revenues and that comment, we estimate the charge was about $250 million or a 23-cent headwind for EPS.

- IBM is guiding to more workforce rebalancing for 2Q too:

  > *"This [guidance] reflects a first-half headwind from currency and workforce rebalancing dynamics, both of which flip to a tailwind in the second half.* ***<u>I mentioned the workforce rebalancing activity we have underway. Between the first and second quarter, the charge should be in the range of $300 million – maybe a little more.</u>*** *We still expect this action to pay back by the end of the year."*

- **IBM will also change its earnings presentation to remove the workforce rebalancing charges.** These ongoing cost items have occured every year and nearly every quarter.

After having it drive EPS when it was materially lower – IBM is now going to report that its segment profits are higher:

> *"__We are no longer including workforce rebalancing charges in our measure of segment profit to provide a view of our segment results__ consistent with our ongoing operational profile."*

- We wondered how the new Z-System roll-out would mature – now we see a large drop against two easy comps. 1Q23 was the last easy comp and Z-Systems only posted a 7% growth rate y/y.

| **Z-System Growth** | **4Q** | **3Q** | **2Q** | **1Q** |
|---|---|---|---|---|
| 2022 | **16%** | **88%** | **69%** | **-19%** |
| 2021 | **-6%** | **-33%** | **-11%** | 4% |
| 2020 | -18% | -15% | **69%** | **59%** |
| 2019 | **62%** | -15% | -20% | -11% |

The bold figures are Z-systems growth, the non-bold figures are the full systems unit's growth rate and Z-systems are were called as leading the full unit.

- IBM did not call out Kyndryl sales for 1Q23 results. Kyndryl had been a big part of IBM's growth in three areas. Software was up only 2.6% or 5.6% in constant currency. Transaction Processing was up 3% or up 7% in constant currency. And Infrastructure was down 3.7% or up 0.1% in constant currency. Infrastructure support was down 9% or down 4% in constant currency.

# Philip Morris International Inc. (PM)
# Earnings Quality Update

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

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

## Summary

PM's adjusted EPS of $1.38 beat forecasts by 4 cents. We do not consider this a quality beat.

- PM guided to a 20.5%-21.5% effective income tax rate and came in at 17.3% - that added nearly 5 cents.

- Equity Investment income looks high at $51 million and was 3.3 cents by itself. We do not know dividends received yet from that area, but with a large Russian investment, the dividends dropped significantly in 2022. The equity method accounting would boost income if the dividend is smaller. ***(See Below for Detail)*****.**

- Pension costs were an $18 million headwind for 1 cent.

- PM reduced guidance due to heavier expected FX losses. Expected 2023 EPS of $6.25-$6.37 with 15 cents of FX headwind is now $6.10-$6.22 with 30 cents of FX.

- PM reported it is still on pace to roll out its heated tobacco in the US in 2Q24, which we still regard as a very positive development for PM's future growth.

- 1Q results and 2Q results are being impacted by the rollout of more ILUMA product that will replace some of the earlier IQOS product. The inventory for ILUMA is building and PM wants to keep lower inventory levels of IQOS in some markets to lessen the risk of write-downs for IQOS product later. That is pressuring some of sales. Guidance is for sales growth and ILUMA to build through the year.

# Equity Investment Income Poses a Risk to Earnings

PM has stakes in several foreign operations, the largest is in Russia which is about 40%-45% of the total equity investments. These are primarily foreign distributors and manufacturers. PM accounts for these based on its share of income boosting the value and losses and dividends received reducing the value. The net change is reported on the income statement. Generally, this is a positive source of earnings:

| Equity Inv. Income | 4Q | 3Q | 2Q | 1Q |
|---|---|---|---|---|
| 2023 | | | | $51 |
| 2022 | $157 | $21 | $15 | -$56 |
| 2021 | $54 | $49 | $3 | $43 |
| 2020 | $20 | $20 | $30 | -$54 |
| 2019 | $63 | $45 | $30 | $11 |

- The only time there were losses were in 1Q22 and 1Q20. As a result,1Q23 had a big swing in equity income of $107 million y/y. The income in 1Q23 was 3.3 cents of PM's adjusted EPS. The y/y swing improved EPS by 6.9 cents.

- We believe the big jump in income in the last couple of quarters may be due to a lack of dividends being received. Because a large investment is in Russia, that likely caused the recent dividends to fall. Normally, there are at least $100 million in annual dividends. In 2022, there was only $9 million and $8 million arrived in 1Q22:

| Eq Investments | 2022 | 2021 | 2020 | 2019 | 2018 |
|---|---|---|---|---|---|
| Dividends received | $9 | $176 | $79 | $100 | $118 |

- This is becoming less cash income. The income looks inflated in the last two quarters. Even PM says there is a risk that it could see impairments, divestments, or losses from Russia.

- Plus, the biggest reason PM gave for reducing guidance was FX headwinds going from 15 cents to 30 cents. The bulk of that is the Russian Ruble. Is the actual value of that investment even worth what it is being valued at these days given the devaluation of the currency? In 4Q, PM noted that its Russian investment was $458 million of the total equity investment of $1 billion. On the call, the CFO noted:

> *"I think you rightly pointed to the ruble actually, if you are not going to disclose currency by currency, but if you look at the ruble,* ***just the ruble is more than the net impact of $0.30 that today we are anticipating for the year****. So I think it shows a very strong impact of the ruble. And the Egyptian pound continue to devaluate after January. So it's -- I'm not sure we had the full impact of the Egyptian pound. If you accumulate ruble and the Egyptian pound, you have 80% of the net impact of $0.30"*

# Procter & Gamble (PG)
# Earnings Quality Update

*We are maintaining our earning quality rating of PG of 4- (Acceptable)*

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

## Summary

PG reported non-GAAP EPS of $1.37 which was 5 cps ahead of consensus. The top line also surprised to the upside by $750 million. While other income growth added about a penny per share to EPS in the quarter, the beat looked solid overall. However, we continue to see several items that warrant caution in upcoming quarters.

- A strong US consumer, better-than-expected elasticity, and recovery in China prompted the company to raise its outlook for organic growth for the year ending 6/23 to 6% from the previous 4-5% range and total sales growth to 1% from the previous -1% to 0% range. However, the company did not increase its forecast for EPS growth of 0-4% and continued to caution that it expects EPS to fall in the low end of the expected range citing input cost headwinds and negative FX as reasons for caution.

- Overall volume fell by 3% while pricing rose 10% and mix kicked in 1% resulting in 7% organic growth. The company continues to see better-than-expected elasticities. The US consumer remains strong and it is not seeing a shift to private labels domestically. However, private-label players in Europe have resisted price increases and are reportedly gaining share of that market.

- Gross margin expanded by 150 bps primarily due to price increases and manufacturing productivity savings. However, much of this was given back in a 100 bps increase in SG&A as a percentage of sales. The primary culprit mentioned was an increase in marketing investment. The company continues to push its strategy of "irresistible superiority" emphasizing to consumers that its higher quality is worth the money. For example, its premium detergent may be more expensive than the discount brand, but you can use less. However, pushing this message is expensive and will likely continue to be a drag on margin growth in upcoming quarters.

- Inventory DSIs were up to 64.7 at the end of the quarter versus 61.9 last year and the high 50s pre-Covid. The company stated in the 10-Q that this was due to “increased safety stock level to strengthen supply chain sufficiency.” Management stated on the call that raw and packaging material costs are still ahead of last year but have “largely stabilized” over the last few months. Given this and how rapidly the company turns its inventories, we are not concerned about a layer of higher-cost inventory being built up.

# Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

# Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

# Disclosure

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