BEHIND
THE NUMBERS
Quality of Earnings Analysis
May 1 , 2023

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Behind the Numbers

Companies in this Issue

Altria Group, Inc. (MO)	p. 1
The Coca-Cola Company (KO)	p. 4
International Business Machines Corporation (IBM)	p. 6
Keurig Dr Pepper Inc. (KDP)	p. 8
Mohawk Industries, Inc. (MHK)	p.11
United Rentals, Inc. (URI)	p.15

Altria Group, Inc. (MO)
Earnings Quality Update

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

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

Summary

MO's 1Q23 adjusted EPS of $1.18 beat forecasts by 1 cent. Guidance is flat at adjusted EPS of $4.98-$5.13. We see several areas to question earnings quality and guidance:

- MO has litigation costs continually, these are not one-time items. It added back 4 cents of litigation costs in 1Q23's adjusted EPS.

- MO picked up 1.6 cents on higher Anheuser Busch Inbev equity method earnings. That's not an operating source of income.

- MO took $472 million in pricing for smoking products in the quarter and operating income was flat. Volume decay is still accelerating, and MO notes that competitors are aggressively pricing in the discount area. If MO lost 5% of this pricing power – it would cut 1 cent off EPS.

- Past share repurchases added 1.8 cents to 1Q23 EPS based on share count falling from 1,818 million to 1,786 million. We see a problem in that MO's guidance relies on repurchasing $1 billion in shares in 2023, about 20-21 million shares. However, with the NJOY purchase coming in 2Q, MO purchased no shares in 1Q and may not start repurchases until 2H23 which may not allow the share count to decline as much as initially planned. Already the sequential change is shrinking:

	1Q23	4Q22	3Q22	2Q22	1Q22
Weighted Avg Shares	1,786	1,790	1,799	1,809	1,818

- There was a headwind related to tax valuation allowances of 3.8 cents in the quarter.

- As we expected last quarter, higher interest expense is sapping benefit income. Compared to 1Q22, the benefit only dropped $8 million or 0.3 cents of EPS headwind. However, that y/y change was helped because 1Q22 amortized a loss. Without that loss, the primary component of this expense/income was a $10 million benefit vs. $44 million the year before. This could be a 1.4-cent quarterly headwind for EPS.

- Smoking income is still what drives the ship here. It was 86% of operating income for 1Q23. Volume continues to plummet on top of already huge volume losses:

Smoking Vol Decay	4Q	3Q	2Q	1Q
2023				-11.0%
2022	-11.0%	-10.0%	-10.0%	-8.0%
2021	-8.0%	-7.0%	-4.5%	-3.5%
2020	-1.0%	-1.0%	-2.0%	-3.5%
2019	-6.0%	-7.0%	-7.0%	-7.0%

- Huge price increases are not leading to operating income growth because of the volume losses. The minor growth in y/y operating income of late has been helped by lower promotional spending.

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Smoking Op. Income	$2,515	$2,603	$2,812	$2,800	$2,511	$2,504	$2,761	$2,784

- On the call, management pointed to promotional spending picking up now. Promotional spending shows up as reductions to pricing. We noted above that a 5% loss of net price increases would be a 1-cent headwind per quarter. Consider management's comments on the call:

> *"we also made a separate announcement making some adjustments to promotional spend in the marketplace. Those adjustments are really down at the local level. And what we are seeing were pockets of area where we felt like Marlboro menthol was under pressure and Sal highlighted in his remarks, stepped up promotional spend by a competitor in the menthol space."*

> *"where we see the consumer under extreme economic pressure, and we're making some adjustments within the Marlboro franchise on promotional spend to counteract and give them a place where they can continue to engage with Marlboro."*

- The California menthol ban led to a 19% drop in 1Q23 cigarette shipment volumes to California. The FDA is still pushing for a nationwide ban.

The Coca-Cola Company (KO)
Earnings Quality Update

We are maintaining our earnings quality rating 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 1Q23 EPS of $0.68 beat forecasts by 3 cents. We see several items that can fully account for the 3 cents plus we see growing pressure from higher inventories, advertising & promotion, with less pricing power:

- Bad debt reserves fell to $512 million from $516 million in December on a 28% increase in gross receivables. That added as much as $148 million to earnings or 2.7 cents per share. Some of the increase in receivables is seasonal as they tend to rise in 1Q vs 4Q. However, the allowance should have increased in line with receivables to keep the allowance percentage constant.

- We still see the excessive pricing taken in Latin America as unsustainable. The difference between Pricing and FX should show a single-digit spread. It dropped to 13% from 19% in 4Q22. But if it's still 5%-7% too high, this added 1.1-1.6 cents to EPS:

Latin America	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Volume Growth	1%	6%	6%	-4%	20%	-10%	11%	29%	2%
Pricing Growth	18%	26%	12%	12%	19%	11%	23%	9%	7%
FX	-5%	-7%	-6%	-1%	-6%	1%	7%	3%	-10%

- Stock compensation was down $29 million – adding 0.5 cents.

- Depreciation was down again and we estimate that added 0.5 cents. This is already helping gross margin and capital spending looks light over several years.

- Pension expense is expected to be a 3-cent headwind for 2023- for 1Q23 it was only 0.2 cents.

- Rounding EPS to two digits added 0.4 cents.

- KO boosted inventory in 4Q by 10 days to more normalized levels. It appears in 1Q23 that inventory has jumped above normal levels. This is important because KO continues to see price increases moderating going forward and expects to see more promotional spending that further lowers pricing. Gross margins are not back to pre-Covid levels and the new inventory likely cost more given inflation. We believe all of that may pressure results going forward:

	1Q23	1Q22	1Q21	1Q20	1Q19
Inventory	$4,727	$3,741	$3,356	$3,558	$3,178
Adj. COGS	$4,282	$4,233	$3,556	$3,291	$3,012
DSIs	99.4	80.4	86.8	94.1	92.9
Gross Margin	60.9%	59.7%	60.6%	61.6%	62.5%
Pricing	11%	7%	1%	0%	5%
FX	-6%	-4%	-1%	-2%	-6%

- Advertising rose y/y by $85 million to $1.065 billion. As a percentage of sales, it was 9.7% vs. 9.3% which cost KO 0.7 cents in EPS. The company is guiding to more spending in this area and this could remain a headwind.

- KO still expects that at some point the IRS will rule against it on KO's allocation of foreign earnings. It issues all of its guidance saying this item is not part of its cash flow forecasts. To appeal a decision, KO's estimate is that it will need to post $5.2 billion in cash. We will still point out that Free Cash Flow is expected to be $9.5 billion and there's an $8.0 billion run rate on the dividend. Plus, KO normally repurchases shares to help EPS growth. We do not think the dividend is at risk, but repurchases may decline and hurt EPS growth in 2023.

International Business Machines Corporation (IBM) Earnings Quality Update

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

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

Summary

Please read part 1 of our IBM 1Q23 earnings update from last week with this note. We now have IBM's 10-Q and can review some areas more thoroughly and firm up estimated figures. We have identified tailwinds of 44-49 cents and headwinds of 27 cents – netting IBM 17-22 cents in short-lived EPS items.

IBM's 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 reduced revenue guidance from Mid-Single-Digit to 3%-5%, with units like Red Hat seeing slower growth than forecast.

- Depreciation came in at $527 million vs. $631 million y/y (and our original estimate of $507). That added 9.9 cents of EPS. IBM reported that the longer assumptions for depreciation lives was 6 cents So, non-GAAP EPS was helped by 3.9 cents in this area.

- IBM cut advertising from $336 million to $314 million – adding 2.1 cents to EPS.

- IBM's bad debt expense fell from $16 million to $2 million – adding 1.3 cents.

- It reversed $17 million out of standard warranty accruals in 1Q23 – adding 1.6 cents.

- The deferral for new extended warranties fell by $9 million y/y – adding 0.9 cents.

- IBM guided to a 1Q charge of $300 million, it only took a charge of $260 million, adding $40 million to pretax income from 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?

- 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.

- **Other income rose to $242 million from $179 million.** IBM guided for this income source to decline significantly in 2023 on 4Q earnings call – specifically because it thought gains on FX derivatives would not be as strong. That was the case as FX was a -$264 million swing. However, this was almost entirely offset by y/y gains in other derivatives of $244 million. These appear to be largely reclassified gains on FX from Accumulated Other Income. The rest of the increase was fueled by interest income rising. We expected that, but not the $244 million in reclassified gains. **We are sticking with our estimate that this was a 10-cent tailwind for EPS** as the guide was for this to be down.

- SG&A was down too. We subtracted all the parts already counted above such as bad debt expense, advertising, the $260 million charge, stock compensation, and workforce rebalancing below. We also pulled out some derivative gains/losses. SG&A in dollar terms fell by $172 million to $3.56 billion. In dollar terms, it added 16.3 cents. As a percentage of operating revenues (not financing income), it was down $280 million or 27 cents. We believe IBM is giving wage increases to many employees, and at least 10-15 cents of this is not sustainable.

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

- Workforce Rebalancing came in at $259 million vs. our estimate of $250 million. Against 1Q22's $5 million, IBM had a $254 million headwind or 24.1 cents.

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

Keurig Dr Pepper Inc. (KDP) Earnings Quality Update

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

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

Summary

KDP's 1Q23 adjusted EPS of $0.34 beat forecasts by 1 cent. Guidance was not raised and multiple items helped the earnings beat that may not be sustainable:

- KDP is guiding to a 22% tax rate and just reported a 19.9% tax rate which added 0.9 cents plus rounding up results added another 0.2 cents.

- KDP has rolled all its foreign operations into one unit, so we cannot isolate Latin American FX – but it did report a 0.5% positive FX impact in the quarter. Last quarter, FX was -6.5% for Latin America. The 7.0% swing should be worth about 0.6 cents in EPS.

- Principal payments on financing leases rose to $24 million from $20 million. This is ignored in EPS entirely but helped by 1.4 cents in 1Q23 vs. 1.1 cents in 1Q22.

- As noted last quarter, KDP continues to add back charges related to productivity and restructuring that are more than 10% of earnings. In 1Q23, this was another 4 cents for productivity. Shouldn't these charges get smaller after years of these actions?

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

- After all the pricing gains and productivity and restructuring programs – it is concerning that gross margins and operating margins are flat to declining. Coca-Cola is forecasting pricing gains to weaken and promotional spending to rise. KDP came into 2023 saying it expected higher marketing too – we only see a mention of that for the US Beverage unit so that headwind could build more. Marketing and R&D were down from 2019 to 2022 by $149 million – representing as much as 8 cents of EPS that could be lost:

	1Q23	1Q22	1Q21	1Q20	1Q19
Pricing	9.9%	6.3%	0.5%	-0.5%	1.1%
Volume	-1.0%	-0.2%	10.3%	5.0%	1.4%
Gross Margin	52.7%	52.7%	55.5%	56.8%	56.7%
Operating Margin	20.8%	23.8%	25.5%	26.2%	24.8%

- Total lease cost continues to rise as a result of KDP's sale-leasebacks. This is supposed to lower depreciation as an offset, but this is a headwind. Total lease cost was $77 million vs $65 million last year while depreciation rose $1 million too. This was a 0.7-cent headwind.

- Stock compensation was a headwind in 1Q23. Last year, KDP had a credit vs. an expense this year. The y/y adjusted swing was $34 million or 1.9 cents of headwind.

- **Payables have reached 281 days, up from 268 days in 4Q.** KDP has factoring set-up for suppliers to sell their KDP debt and collect cash more quickly. Suppliers have sold $3.9 billion or 222 days of KDP's payables. There is still no comment concerning the rising cost of doing this to the suppliers, but this isn't free anymore. It should be costing suppliers 5%-6% in interest expense . We still believe this is debt that KDP may be forced to deal with on short notice. KDP does not have $3.9 billion in available cash, only $204 million and its credit line that will cost it more interest expense.

- **Total debt continues to be misleading. KDP only looks at bank and bond debt less cash.** We believe the factored payables of $3.9 billion should be viewed as debt too as well as structured payables (a corporate credit card) of $137 million, and the PV of finance leases of $915 million. KDP considers its debt to be $12.2 billion and 3.0x trailing EBITDA. We think it is nearly $5 billion higher and 4.25x trailing EBITDA.

- It is worth noting that coffee has seen -6.6% volume decay in 1Q with pods down 1.9% and brewers down 9.8%. Pricing is not that strong for coffee either at 5.5%. The 12.5% pricing gain for US Beverages looked high and KDP seems to be relying on large pricing continuing for that unit. Every 100bp of pricing that doesn't hold at that unit is 1 cent of EPS headwind per quarter.

Mohawk Industries, Inc. (MHK)
Earnings Quality Update

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

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

Summary

MHK blew the consensus away in 1Q 23, topping EPS targets by 46 cps. This was driven by sales coming in over $65 million ahead of consensus, which management attributed to better-than-expected pricing/mix. However, we continue to have concerns regarding the quality of the quarter and believe another increase in DSOs could have been a significant contributor to the revenue surprise in addition to other benefits.

- DSOs rose by 5 days YOY and 2 days sequentially. This could have been partially influenced by acquisitions closed during the quarter but we believe that was likely not much for than a day of sales impact. This is the second straight quarter of DSO increase even though both quarters saw declining revenue and customers trimming their inventories. ***(See below for details.)***

- Despite the increase in average capitalized contract costs, the related amortization expense fell by $4 million sequentially, 3.5% on a percentage basis YOY, and 6.6% on a percentage basis sequentially. To put this in perspective, if the amortization expense percentage had been in the more normal 25% range, it would have shaved over 3 cps off of EPS growth in the quarter. We expect this to return to a more normal range over the year which could be a mild headwind to earnings growth. ***(See below for details.)***

- The company added back 40 cps in restructuring costs. While the company occasionally has quarters without huge charges, charges amounting to at least 15% of earnings are typical for MHK which greatly reduces the quality of adjusted results in our opinion.

Receivables Continued to Rise

DSOs jumped by over 5 days YOY in the first quarter and over two days sequentially. On the call, management said "Receivables were just shy of $2.1 billion, with DSO at 56 days versus 54 in the prior year, but improving from 60 days as of the end of the year of 2022. The company breaks out its accounts receivables into trade receivables, other receivables, and tax receivables. The $2.1 billion figure cited by the company appears to include all three. We are also uncertain how the company calculates its DSO figure. We prefer to calculate DSOs on a quarterly basis and to remove the impact of tax receivables. Our calculations of receivable DSOs are shown below for the last seven quarters:

	4/1/2023	12/31/2022	10/01/2022	7/2/2022	4/2/2022	12/31/2021	10/2/2021
Revenue	$2,806.2	$2,650.7	$2,917.5	$3,153.2	$3,015.7	$2,760.7	$2,817.0
Gross Customer Trade Receivables	$1,919.5	$1,699.1	$1,899.5	$2,003.4	$1,947.0	$1,721.6	$1,820.8
Allowance for Discs. Claims, & Doubtful Acct	$81.8	$73.8	$71.7	$73.7	$73.2	$73.1	$78.2
Net Customer Trade Receivables	$1,837.6	$1,625.4	$1,827.7	$1,929.7	$1,873.8	$1,648.4	$1,742.5
Trade Receivables DSOs	59.6	55.8	57.0	55.7	57.2	53.7	56.3
Other Receivables	$190.9	$219.4	$148.3	$132.8	$111.5	$117.8	$108.5
Other Receivables Days of Sales	6.2	7.5	4.6	3.8	3.4	3.8	3.5
Trade and Other Receivables DSOs	65.8	63.3	61.6	59.5	60.6	57.6	59.8

Points to note:

- MHK completed two acquisitions in the quarter although we are uncertain as to the exact date of the close. This could have influenced the DSO calculation as the receivables balance would have been increased on the day of acquisition, but revenues would have reflected just the time the new operations were owned. Still, based on the value of the acquisition assigned to working capital and what the company disclosed about inventory balances, we doubt DSO was inflated by much more than a day.

- We assigned all of the allowance to trade receivables. The net DSO of the trade receivables rose by 2.4 days YOY and 3.8 days sequentially. This follows a more than 2-

day YOY increase in the 12/22 quarter which the company blamed at the time on “customer and channel mix.”

- The company has prominently noted that its customers have been cutting their inventories in preparation for a slowdown which is consistent with what we are hearing from the big box retailers. Two straight of slowing sales and rising DSOs when customers are trimming stock is a concern. The bulk of the company’s earnings surprise came from sales coming in about $60 million higher than Wall Street was expecting. One day of sales amounts to about $31 million in revenue which implies the DSO increase could have been responsible for much of the upside.

- We are uncertain as to the composition of other receivables where DSOs jumped by 2.8 days YOY. However, other receivables declined sequentially on an absolute and days of sales basis.

Amortization of Capitalized Contracts Fell

MHK capitalizes contract costs which include the cost of setting up in-store displays. However, despite an increase in average capitalized balances, the amortization of those costs fell on an absolute and percentage basis. The following table shows the calculations of the amortization percentage for the last twelve quarters:

	4/1/2023	12/31/2022	10/01/2022	7/2/2022
Ending Balance Capitalized Contracts	$63.082	$59.015	$60.457	$58.451
Average Capitalized Balance During the Quarter	$61.049	$59.736	$59.454	$53.747
Amortization of Costs to Obtain Contracts	$13.099	$17.126	$13.518	$12.536
Amortization % of Average Capitalized Balance	21.5%	28.7%	22.7%	23.3%

	4/2/2022	12/31/2021	10/2/2021	7/3/2021
Ending Balance Capitalized Contracts	$49.042	$49.644	$57.065	$58.012
Average Capitalized Balance During the Quarter	$49.343	$53.355	$57.539	$56.278
Amortization of Costs to Obtain Contracts	$12.340	$17.639	$13.846	$14.615
Amortization % of Average Capitalized Balance	25.0%	33.1%	24.1%	26.0%

	4/3/2021	12/31/2020	9/26/2020	6/27/2020
Ending Balance Capitalized Contracts	$54.544	$59.847	$62.596	$62.196
Average Capitalized Balance During the Quarter	$57.196	$61.222	$62.396	$64.581
Amortization of Costs to Obtain Contracts	$15.581	$17.091	$16.356	$19.214
Amortization % of Average Capitalized Balance	27.2%	27.9%	26.2%	29.8%

Points to note:

- Average capitalized balances rose both YOY and sequentially. The increased rate of capitalization seems unusual given the fact that home improvement retailers are keeping inventory low. However, management has cited increased marketing investments which could conceivably include an increase in in-store display placement so we won't dwell on that point for now.

- Despite the increase in average capitalized balances, the amortization of those capitalized costs fell by $4 million sequentially, 3.5% on a percentage basis YOY, and 7.2% on a percentage basis sequentially.

- To put this in perspective, if the amortization expense percentage had been in the more normal 25% range, it would have shaved almost 3 cps off of EPS growth in the quarter. We expect this to return to a more normal range over the year which could be a mild headwind to earnings growth.

United Rentals (URI) Earnings Quality Update

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

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

Summary

URI's 1Q23 adjusted EPS of $7.95 missed by 4 cents. The company confirmed guidance, which seemed to disappoint the market but it is calling for 10%-14% top-line growth excluding the Ahern acquisition and 17%-22% EBITDA growth. The company is only trading for 9x forward EPS and 5.4x adjusted EBITDA. The market is also disappointed by the Ahern deal reducing the EBITDA margin in 1Q23, which we will discuss below. We would note that 2022's EBITDA margin was 48.3% and guidance URI just confirmed again is for 48.2% in 2023 with Ahern. The higher 2023 sales forecast produces over $1 billion in additional EBITDA. The 10bp drop in margin only offsets that EBITDA growth by $14 million in 2023.

- URI had bad debt expense rise by $7 million cutting EPS by 7.5 cents.
- Advertising reimbursements fell by $6 million which should have helped EPS by 6.5 cents.
- Share compensation was flat y/y – that normally is a headwind to EPS.
- Share repurchases slowed with the Ahern deal and were only $10 million in 4Q and 1Q23 was slightly below 1Q22 as well – this is a headwind for EPS.
- Adjustments to EPS remain consistent with past policies – restructuring charges after the acquisition were only 2 cents of the $7.95 in EPS and URI always adds back amortization of acquired intangibles.
- Inflation increased the value of acquired fleet equipment. Assigning more of the purchase price to that area means it will be expensed quickly. It also hurts gross margin via higher depreciation on rentals and higher cost of sales with that equipment is sold. This hurt GAAP EPS by 76 cents in 1Q23 and we think this can explain some of the margin decay.

- The shock over a weaker EBITDA margin with the Ahern deal seems overblown to us. URI was clear that it was acquiring a company with a lower margin and it only owned it for one quarter so the synergies are not completely in place. The drag from the acquisition was 90bp based on pro forma information **(See Below).**

- Synergies are expected to be more focused on boosting sales and leveraging Ahern's equipment and fixed costs further. That is forecast as $60 million. That will take more time to materialize than simply rationalizing real estate and labor which should add $40 million. We estimate that Ahern's margin should rise by about 9 percentage points if URI is successful **(See Below).**

- The sequential decline in margin was larger than just Ahern. This has happened every 4Q to 1Q for years. Some of that is heavier sales of used equipment in 4Q, which has a higher margin. Pricing gains have been solid for many quarters and the growth rate is slowing – that likely played a role too **(See Below).**

- The Ahern acquisition appears conservative to us. Only 5% of the purchase price went to goodwill and the bulk of the price will be amortized or depreciated over short time frames. The price was only 6.5x EBITDA or 4.9x if the synergies are realized. **(See Below).**

- We still think EBITDA is too aggressive of a metric because URI's rental equipment depreciation is lower than net equipment purchases – making that depreciation a cash cost. We believe EBITDA should be viewed as $1.0-$1.5 billion lower than what is reported. Under that adjustment, debt rises from 1.7x EBITDA to 2.0-2.2x – still reasonable and the market value is still under 7x EBITDA up from 5.4x. **(See Below)**

The Sequential EBITDA Margin Drop Shouldn't Be Surprising

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
Adj. EBITDA Margin	45.8%	50.0%	49.9%	47.3%	45.1%	47.2%
Gross Profit Margin	37.8%	45.1%	44.8%	41.5%	39.3%	41.8%
Gross Profit on Eq. Sales	49.0%	43.6%	61.9%	59.1%	55.0%	41.5%

- EBITDA adds back the depreciation of rental equipment so it also adds back the higher depreciation resulting from marking acquired equipment to fair market value amid inflation. It also adds back the markup of acquired equipment when it is sold. **The gross margin does not add those mark-up items back.** For 1Q23, those items had a negative impact on total gross profit margin of $71 million, or 2.2%, and $41 million of the $71 million impacted the margin on equipment sales and cost 10.5% of that margin.

- **Ahern was a lower-margin company to begin with as the EBITDA margins prior to the deal were 35% vs URI at 48%.** Simply sticking the trailing 12 months for each together reduces the EBITDA margin by 1.0%. URI shows a proforma for 1Q22 for a merged company and the EBITDA margin fell by 90bp against the reported stand-alone URI business in 1Q22. It is worth noting that against the pro forma for 1Q22, EBITDA margins rose 160bp y/y:

	Combined 1Q23	Proforma 1Q22	URI actual 1Q22	Ahern 1Q22
Adj. EBITDA Margin	45.8%	44.2%	45.1%	33.0%

- URI has only owned this company for one quarter. They are keeping much more of the operating locations, employees, and equipment than several previous deals because Ahern fills a geographic need. URI is only forecasting $40 million in total cost savings. That would add 450bp to Ahern's margins. However, that only helps total combined by 30-40bp. URI noted on the earnings call that compared to proforma results, it gained about 10bp in gross margin in the 1Q so far.

- URI expects to gain about $60 million in new revenue from Ahern's business by cross-selling to its client base with a broader array of equipment. That won't change the fixed cost of that equipment, it will simply be spread over more revenue and should create margin leverage. That does not happen overnight and will build over a year or more. The end result could look like this:

  - Ahern pre-deal $877 million in revenue, $310 million EBITDA = 34.9% margin
  - Add $60 million in revenue and remove $40 million in costs
  - Ahern post-synergy $937 million in revenue, $410 million EBITDA = 43.8% margin
  - 2022 for URI with almost no Ahern help – EBITDA margin was 48.3%
  - If all Synergies are achieved, with no growth for URI business the eventual combined entity should have a margin of about 47.9%.
  - URI is already projecting stronger margin improvement than that for 2023 with a 48.2% forecast.
  - All of this was discussed on day-one, so we're surprised at how the market reacted so negatively to Ahern hurting margins.

- The sequential drop in margin from 4Q22 to 1Q23 was not a new event either. The 1Q is normally seasonally weaker on margin. That is likely a combination of fixed costs for wages and rent with a lower amount of equipment on rental. Also, margins on the sale of used equipment often exceed the margins on rentals and 4Q is a heavy period for equipment sales and 1Q is more of a low point. Here are the last seven years of sequential margin change from 4Q to 1Q:

EBITDA Margin	4Q	1Q	Seq. chg.
2022 to 2023	50.0%	45.8%	-4.2%
2021 to 2022	47.2%	45.1%	-2.1%
2020 to 2021	45.5%	42.4%	-3.1%
2019 to 2020	47.0%	43.1%	-3.9%
2018 to 2019	48.4%	43.5%	-4.9%
2017 to 2018	49.3%	45.0%	-4.3%

  - We know that Ahern was 90bp of 1Q23's sequential decline, making the 330bp organic decline well inside the normal seasonal pattern.

- Also, fleet productivity is still positive. But the rate of change is coming down against very high comps. This is a measure of price hikes, time equipment is on rental and rental mix. Having this compound has helped margins of late, it may be leveling off a little in 1Q23 a bit:

Fleet Productivity	4Q	3Q	2Q	1Q
2023				5.9%
2022	5.9%	8.9%	11.3%	13.0%
2021	10.3%	13.5%	17.8%	-0.5%

Ahern Deal Accounting Does Not Look Aggressive

The deal cost $2 billion. The ROI based on current EBITDA is 15.5%, with synergies it would 20.5%. The cost was 6.5x EBITDA or 4.9x if synergies are realized. None of that looks too pie-in-the-sky.

The allocation also looks conservative. Only $105 million is Goodwill, which will not be expensed. URI adds back the amortization of acquired intangibles to EPS. It has $260 million allocated to Customer Relationships and $190 million allocated to Non-Compete Agreements. Offsetting that URI adds that amortization back to non-GAAP earnings is the rapid amortization period of 5 years for Non-Competes and 9 years for Customer Relationships.
$1.5 billion is going to rental equipment and other property and equipment. All of that will be depreciated and flow through EPS.

This deal looks in line with past deals in terms price, some modest planned synergies, and URI is buying a growing business. The biggest difference is URI is planning on lower cost savings and more revenue synergies:

Acquisition	Year	Price $bill	Pr/EBITDA
Blueline	2018	$2.1	6.7
Baker	2018	$0.7	9.0
Neff	2017	$1.3	6.3
NES	2017	$1.0	6.2

Acquisition	Synergy $mm	EBITDA $mm	Adj EBITDA price
Blueline	$45	$313	5.4
Baker	$19	$79	6.6
Neff	$35	$207	5.4
NES	$40	$155	4.3

We Still Believe EBITDA Should Be Viewed Net of Capital Spending

It is common to use EBITDA to value many companies. That adds back depreciation and does not subtract capital spending as though that is discretionary. Given that URI's business model is to offer customers newer equipment on rental and it generally sells used equipment after only 2-8 years, it needs to continually replace the equipment. Also, the sales of used equipment is annually about 10% of URI's total revenues and EBITDA. If it stops recycling equipment, that source of earnings would disappear too.

	2022	2021	2020
Rent Eq. Depreciation	$1,853	$1,611	$1,601
Rent Eq. Purchased	$3,436	$2,998	$961
Rent Eq. Sold	$965	$968	$858
Net Purchased/Sold	-$2,471	-$2,030	-$103
Adj. EBITDA	$5,618	$4,414	$3,932

- There is a considerable amount of rental equipment depreciation that goes into EBITDA. It is roughly 35% of the total EBITDA

- But, the cash spent on new rental equipment exceeds that depreciation in every year except Covid's 2020.

- Net new purchases less cash received from selling old equipment is still a net cash outflow each year too. It also normally exceeds the depreciation figure.

There is a growth component to the rising rental equipment purchases. Guidance is for this to remain over $2 billion for 2023 as well. In our view, it is likely a fair estimate to call $1.0-$1.5 billion of that spending a necessary cash expense. URI cannot postpone that spending very long either without hurting the business model. To us, we consider the EBITDA to be too high by about that same $1.0-$1.5 billion.

To URI's credit, it does highlight its Free Cash Flow as much as EBITDA. Using a lower EBITDA figure does not really derail this situation either. The forecast for EBITDA in 2023 is $6.6-$6.85 billion. If we cut that by $1.0-1.5 billion from the midpoint of $6.73 billion here is how this looks:

	Guide	**down $1.0**	**down $1.5**
2023 EBITDA	$6,730	$5,730	$5,230
Debt	$11,648	$11,648	$11,648
Debt/EBITDA	1.7	2.0	2.2
Market Cap	$36,300	$36,300	$36,300
EBITDA multiple	5.4	6.3	6.9

We still would not consider this over-leveraged or a very expensive stock based on a more realistic view of EBITDA.

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

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.