BEHIND THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

Companies in this Issue

Axalta Coating Systems Ltd. (AXTA)
Earnings Quality Review

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

We are initiating earnings quality coverage of AXTA with a 4+ (Acceptable) rating.

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

Summary

Axalta (AXTA) is the LBO for the Dupont Performance Coatings business in 2013. There have been two other large acquisitions since and several smaller ones. 40% of the business involves refinishing cars involved in accidents – ultimately paid by insurance. Another 32% is selling paints and coatings to vehicle manufacturers and the other 28% is for coatings for home/building construction along with outdoor equipment and pipelines. About 40% of revenue is non-cyclical.

AXTA routinely beats forecasts for adjusted EPS:

	1Q23	4Q22	3Q22	2Q22
Adjusted EPS	$0.35	$0.38	$0.39	$0.41
Beat	$0.04	$0.03	$0.00	$0.02

- 1Q23 was helped by the tax rate and interest expense coming in below guidance for 1.2 cps and 0.6 cps. Depreciation fell $1.1 million adding 0.4 cps.

- 1Q23 was hurt by rising inventory reserves of $2.6 million for a headwind of 0.9 cps and bad debt expense was $4.6 million vs -$0.5 million in 1Q22 for a 1.6 cps headwind.

- The beat looks real to us and was helped largely by 9.4% pricing as AXTA notes that raw materials inflation is moderating. If AXTA loses 1% of pricing that's 4 cents of EPS.

- Until 2019, Axalta did not add back the higher depreciation expense and amortization of the 2013 DuPont deal. That was 6 cents of 1Q23 EPS.

Our 4+ (Acceptable) rating is based on the fact that many of the one-time items being added back are actually one-time items. Small impairments, debt refinancing costs, and some severance charges are the bulk of these. None of them are overly critical and several have become smaller. Working capital items were elevated but now are normalizing. We can see some near-term margin expansion that may come via easy comps and some pricing gains still annualizing. We would be leery that pricing gains may not last much longer and could start to crimp margins again after this year. Plus, FX is not an imaginary item here – it is a key reason why the top line never grew in 10 years until 2022's price hikes. Guidance is for only a -1% headwind from FX in 2023, which would be much better than normal.

What to Watch

- ***Growth is weak.*** Through three major acquisitions, AXTA was able to drive sales to over $4.6 billion. However, sales flatlined there in 2018 and only reached that level again in 2022 when helped by a huge 10% price increase. ***(See below for details)***

- ***Investors should be most concerned with the lack of volume growth- it has been flat for over ten years.*** We will not deny that semiconductor chip shortages hurt auto production and China lockdowns hurt business in 2021 and 2022. Maybe, AXTA should be getting 5% growth as that normalizes – but that's still poor. Plus, what was the excuse pre-Covid? ***(See below for details)***

- ***In most years, pricing is weak and FX more than offsets the pricing gain.*** Other than 2021, FX has been a negative drag on sales to at best neutral for 10 years. AXTA does business in Turkey, China, Mexico, and Brazil which are areas that often have sizeable FX devaluation. This looks like a real cost and we would not be focusing too much on growth figures that exclude it. Much of the guidance still calls for taking pricing even as raw materials retreat. That seldom lasts for long. ***(See below for details)***

- ***Growth for earnings is being boosted via share repurchases of late**.* However, guidance is for a flat share count in 2023. AXTA picked up 6 cents in 2022 and 3 cents in 2021 from repurchases. This has helped recent earnings beats that may not repeat. Higher working capital has reduced cash flow of late and the goal is to still lower debt to 2.5-3.0x EBITDA down from 3.7x.

	2022	2021	2020	2019	2018
Share Count	222.3	231.9	236.0	235.8	242.9
FCF	$143	$437	$427	$461	$353
Repurchases	$200	$244	$26	$105	$254

- ***Growth has also been supplemented via continual restructuring helping margins**.* One of the largest earnings drivers is the drop in depreciation from $177 million to $117 million. That is 20 cents in earnings. AXTA has continually used accelerated depreciation – which it adds back as restructuring – and kept capital spending below depreciation figures to drive this. This has been seen particularly in gross margin – a $10 million drop in depreciation is worth 20-25bp of gross margin. It is also worth noting that in 2018, new revenue recognition standards went into effect (ASU-2014-09) which boosted cost of goods sold for a 140bp headwind on gross margin.

	2022	2021	2020	2019	2018	2017	2016	2015	2014
Depreciation	$117	$128	$137	$170	$183	$177	$177	$169	$177
Capital Spend	$151	$122	$82	$113	$143	$125	$136	$138	$188
Accel Deprec	$4	$3	$9	$24	$10	$4			
Gross Margin	29.0%	32.4%	34.2%	34.9%	33.9%	36.5%	38.0%	36.4%	33.6%

- ***There appear to be several transitions coming for gross margin in the near future***:
    - Raw material inflation has hurt gross margin in 2022 and 2021 and that is now moderating and declining – which should help gross margin.
    - If that hurts pricing going forward, AXTA could see the gains being short-lived, but the lower depreciation should show its positive impact during this time.
    - Capital spending finally exceeded depreciation in 2022 and guidance is calling for $190 million in spending in 2023 – so depreciation should start rising again soon.
- ***AXTA has successfully cut overhead costs over time.*** Employee count rose to 13,300 and has now declined to 12,000 at the end of 2022. The company routinely takes charges for termination and employee items that it adds back to adjusted earnings as well as restructuring/strategic review items. As those charges slow – the percentage of spending on SG&A drops in a very visible manner. SG&A has improved by 700bp over the last 10 years. Keep in mind, there are years when these charges are $80-$100 million – which is 180-220bp of margin gain as those charges shrink. Also, ASU-2014-09 in 2018 lowered SG&A by $64 million and added 150bp to margin by reducing SG&A. So half the margin boost can be explained by the accounting change and the charges getting smaller. The question now is how much more can AXTA do here? Management expects to pick up some more margin as delivery charges have dropped and supply chains have normalized.

	2022	2021	2020	2019	2018	2017	2016	2015	2014
Sales	$4,884	$4,416	$3,738	$4,482	$4,696	$4,377	$4,074	$4,087	$4,362
SG&A	$772	$739	$695	$822	$876	$998	$963	$915	$992
SG&A %	15.8%	16.7%	18.6%	18.3%	18.7%	22.8%	23.6%	22.4%	22.7%
Term/Employee	$24.9	$36.9	$74.9	$35.2	$81.7	$35.3	$61.8	$36.6	$18.4
Strat. Review		$9.7	$30.7	$13.4			$10.4	$23.9	$36.3

- **Inventories are declining again. That may also help gross margin and cash flow.** AXTA uses average cost accounting for inventory so COGS should decline with lower raw material costs more quickly than under FIFO:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Inv. DSI	79.7	88.2	87.0	82.1	82.1	76.6	83.7	74.3

- **The acquisition policies are conservative in several areas.** AXTA does not pay sizeable multiples for the big deals, it amortizes intangibles over a reasonably short period, it has not changed amortization and depreciation lives to massage earnings, and the U-Pol deal came with a much higher margin already and should help AXTA's profitability overall. ***(See below for details)***

- ***Watch out for ROI.*** AXTA bought DuPont's Coatings business at an 8.3% ROI. Margin gains from operating with fewer employees should be real but, we doubt margin gains from pricing will be lasting. Also, only in 2019 did AXTA start to add back the depreciation and amortization from the DuPont deal – that change alone adds about 200bp to AXTA's ROI now. When we adjust for that, ROI was 10.5% and 11.6% for 2022 and 2021. ***(See below for details)***

There Is Minimal Growth Here

One of the first things we ask about companies that do several acquisitions is "did they buy something that was seeing growth?" We are seeing very little evidence that is happening over time at Axalta. There were three major acquisitions here: DuPont's Performance Coatings business in early 2013, Valspar's Industrial Wood unit in June of 2017, and U-Pol in September 2021. There have been several other minor deals over the years that should have added to sales but not to the same extent as the primary ones.

If we add it up, DuPont had sales of $4.26 billion, the Wood deal $225 million, and U-Pol $145 million. So Axalta acquired $4.63 billion in sales along with some other miscellaneous deals. Here is the top line going back to 2014:

	2022	2021	2020	2019	2018	2017	2016	2015	2014
Sales	$4,884	$4,416	$3,738	$4,482	$4,696	$4,377	$4,074	$4,087	$4,362

- Covid hit in 2020 hurting car production, some construction, and there were fewer accidents.

- Auto production was also hurt after Covid by lack of semiconductor chips.

- Axalta didn't exceed its acquired sales figure of $4.63 billion until 2022 and only matched it once in 2018. And it should be understood that 2022 was helped by a 10% price increase on top of a 4% price increase in 2021.

- Volume growth has been non-existent:

	2022	2021	2020	2019	2018	2017	2016	2015	2014
Volume Change	3.7%	10.5%	-15.1%	-3.7%	0.6%	0.2%	2.2%	3.9%	1.2%
Volume Index	101.5%	97.8%	88.5%	104.3%	108.3%	107.7%	107.5%	105.2%	101.2%

- If one wanted to argue Covid and the semiconductor shortage afterward cost the company a few points of growth that should return, we would not argue with that. Maybe, indexed unit growth could have been 103%-104%. But, over 10 years, that still does not look like growth to us.

- This also does not look like a company that can regularly take large price increases. In 2022, commodity prices and inflation led to a large 10% jump, but the past shows many more 2% moves. At the same time, FX has been a drag on pricing:

	2022	2021	2020	2019	2018	2017	2016	2015	2014
Pricing	10.1%	4.0%	-0.1%	3.2%	2.6%	-1.0%	2.6%	1.4%	2.8%
Volume Index	128.2%	116.5%	112.0%	112.1%	108.6%	105.9%	107.0%	104.2%	102.8%
FX	-4.9%	1.8%	-0.8%	-3.0%	0.6%	0.4%	-4.6%	-11.6%	-2.0%
FX Index	77.8%	81.8%	80.3%	81.0%	83.5%	83.0%	82.7%	86.6%	98.0%

- Much of the heavy FX losses were related to Venezuela from 2014-17. In 2015, there was a 1.2% FX hit just from the $51.5 million in Venezuela FX losses. That does not fully eliminate FX as a headwind. But, investors should also note that 2021 was largely an anomaly for FX vs. the dollar.

- AXTA still does significant business with China, Turkey, Brazil, and Mexico. There is recent history of high inflation and currency devaluation in all those places. We have been very skeptical of companies like Sealed Air (SEE), Keurig Dr. Pepper (KDP), and Mondelez (MDLZ) reporting price hikes from Latin America and Turkey and ignoring the FX hit when they tout organic growth. Our view is getting a 15% price hike that comes with a -18% FX hit should be viewed more as flat pricing. But currency-neutral or organic growth figures make it look like the country with large devaluation is the strongest market in the world.

Axalta can legitimately say in recent quarters there were shut-downs in China and inflation, plus semiconductor shortages for new car production stalled some sales there. Some normalization there may provide some top-line gains. They are also unlikely to fully keep some of the recent pricing too. FX is a real headwind more often than not and almost offsets the pricing. Volume gains may at best be 5% over a decade. To grow, the company probably has to rely more on it coming from other methods such as more cost cutting, more share repurchases, and perhaps more acquisitions.

Acquisition Policies Look Conservative… but Watch ROI

Axalta looks to make tuck-in acquisitions but has really only done three sizeable deals. There are several areas that we will point out here as positives:

- There is considerable goodwill of $1.5 billion and intangibles of $1.1 billion. However, Axalta does not assign all of this to indefinite-lived assets. That has been less than 20% of the acquired intangibles.

- Axalta has not changed its depreciation lives or amortization lives after doing deals. The only exception we have seen is software (a small account) is now amortized over 5-15 years vs. 5-7 years in 2014. Intangible tech assets are being amortized over 10 years and trademarks over 15 years. We see tech companies with longer schedules who also magically value the customer relationships of one deal at 7 years and the next deal at 15 years.

- It would be tough to make a case of overpayment:

    - The DuPont deal was $4.9 billion with sales of $4.26 billion, so 1.15x sales, EBITDA of $520 million or 9.44x. The ROI on EBIT was 8.3%

    - The Valspar deal had a purchase price of $430 million and sales of $225 million or 1.9x. But nothing was disclosed on EBITDA.

    - U-Pol was more expensive at $620 million for $145 million in sales for 4.27x, but EBITDA of $38 million for 16x EBITDA. But U-Pol had a 26% margin vs. DuPont at 12.2% on EBITDA. ROI is only 6.1% on EBITDA. We don't have an EBIT figure.

- This another place to start looking for margin improvement at Axalta – it simply bought a much more profitable company in U-Pol that is 14% of sales.

Where we do have an issue is Axalta is adding back the stepped-up deprecation of the DuPont assets and the amortization of DuPont deal to both EPS and adjusted Operating Income. With the EPS side – AXTA earned 35 cents in 1Q23 and 38 cents in 4Q22. This added 6 cents to

1Q23 and 8 cents to 4Q22 EPS. Interesting to note – Axalta DID NOT add this back until 2019. Until they did, 2018's Adjusted EPS was $1.28. In 2019, the 2018 Adjusted EPS was changed to $1.70.

Also, we believe this depreciation expense cost cash as part of the $4.9 billion purchase price. If we do not add it back to operating earnings, ROI in 2022 was 10.5% and 11.6% in 2021. That's not incredible – but adding the DuPont amortization and depreciation back is worth another 200bp for ROI. The purchase price matters. The Rooney family owns the Pittsburgh Steelers for about $50,000. The Washinton owners are in for $6 billion. They get the same share of TV money – who has the higher ROI?

In the next few quarters, we expect AXTA to see better margins and sales with the price hikes. It doesn't have to lose much of the recent pricing gains to move EPS and ROI down. A 1% drop in pricing is about 4 cents per quarter in EPS or 16 cents per year. It's also about 100bp of lower ROI.

Ball Corporation (BALL)
Earnings Quality Update

BALL reported non-GAAP EPS of 69 cps in the 3/23 quarter which was 18 cps ahead of consensus. Roughly 7 cps of this was generated by a benefit from a virtual power agreement settlement. While the company was expecting this benefit, it had not discussed it with the Street so it was not factored into analysts' models. Even without this benefit, the beat appears solid.

BALL must continue to work off its inventory overhang and it may be well into the second half before its customers begin to enjoy any meaningful improvement in volumes. This will keep cash flow under pressure and delay deleveraging. However, we continue to include BALL on our On-Deck Value list as the volumes are almost certain to return, it will begin to enjoy the benefit of inflationary cost pass-throughs in the second half, and costs are likely to continue to moderate. As conditions normalize, the cash flow will return and deleveraging can resume.

We noted the following in the first-quarter results:

- Global can volume was down 1.4% which was in line with expectations. The company is remaining very conservative in its guidance, calling for a full-year volume increase of "low-single digits" excluding the impact of Russia. This appears to be a downgrade from its post-fourth quarter 2023 guidance of 4% volume growth with the less optimistic view spread across all the major segments:

	4Q guide	1Q guide
North America	"flat to slightly down"	"slightly down"
South America	"up mid-to-high single digits"	"up mid-single digits"
EMEA	"up high single digits"	"up mid-single digits"
Other non-reportable	"up mid-to-high single digits"	"up mid-to-high single digits"

- While BALL expects increased promotion by beverage companies to drive increased volume, it emphasized that the recovery will be loaded towards the back half of the year and referenced the easy comps the fourth quarter will enjoy.

- BALL’s contracts allow it to pass through aluminum costs at the time of sale. Lower aluminum prices pressured sales growth in the quarter. Analysts should remember that while falling aluminum prices will not impact gross profit dollars under these contracts, they will artificially inflate gross margins.

- In addition to the aluminum price pass-through provision, many of the company’s contracts contain PPI inflators that rise with inflation. Unlike the aluminum pass-throughs, these amounts kick in at contract renewal which will not begin to happen for the bulk of the company’s contracts until the second half of the year. Management noted that these provisions generally do not deflate, so even if non-aluminum costs reverse, it will still be able to enjoy the increase in revenue dollars and the moderating or potentially falling costs in the second half.

- BALL’s biggest overhang remains its buildup of inventories resulting from lower-than-expected demand in 2022 as its beverage customers saw their volumes collapse due to them raising prices and cutting promotions. The company is working down its raw materials balances and total DSIs were stable YOY at 69.3. This is still elevated when compared to the pre-Covid levels of 45-50 due to higher costs and unexpected slow demand. The reduction in new purchases should help cash flow as the company continues to work down inventory balances as volumes hopefully pick up in the second half.

- Meanwhile, payables continued to trend down, falling to 115 days compared to 150 a year ago. Payables/Inventory stands at 1.7, compared to 2.0 at 12/22 and 2.2 a year ago. It is important to keep in mind that the decline in payables is a result of a decline in purchases rather than suppliers pressuring the company. They are also being deflated by lower aluminum prices compared to a year ago.

- Note that BALL began disclosing more data surrounding its payables factoring programs in the 3/23 10-Q, reporting that the amount of obligations under the programs was $608 million as of 3/23, down from $930 on 12/22. This amounts to roughly 20% of outstanding payables. This should be monitored quarterly moving forward for signs of rapid expansion of the program. We would be surprised to see this happen given rising rates driving up the cost of these programs.

- In the 3/23 quarter, balance sheet DSOs fell by 1.2 days sequentially and 7.0 days YOY. However, this was more than offset by a 13.9-day jump in factored DSOs. On the positive side, adjusted DSOs fell by 0.8 days sequentially illustrating that the rate of factoring did not accelerate. The sequentially flat adjusted DSOs also reduce the concern that sales were pulled into the quarter with more favorable payment terms. Revenue growth is expected to pick up in the back half of the year which will increase receivables. We will be watching to see if the company chooses to accelerate factoring in the second quarter. The company does not disclose the cost of factoring quarterly but as with the payables facilities, we know this source of liquidity is becoming more expensive. ***(See below for detail)***

- Pension expense fell by 2.7 cps. Like most companies, higher interest rates are driving up interest cost while pushing service cost down. These two components resulted in a net increase to expense of $5 million. However, this was more than offset by a $9 million increase in the expected return on plan assets and a $7 million decline in the amortization of net actuarial loss. While both of these factors should continue to contribute to lower pension expense during the year, we consider the increase in expected return and the decline in amortization of actuarial loss to be low-quality sources of growth.

- The benefit from the company's extension of useful lives in calculating depreciation continues, adding 6 cps to earnings in the quarter. The new rates went into effect on July 1, 2022, which gives the company one more quarter of non-operational tailwind. Also, amortization of intangibles fell by 1.5 cps driven mostly by the write-off of intangibles related to the Russian operations in the second quarter of 2022.

Adjusted Receivables Remain Elevated

The following table shows the calculation of DSOs adjusted for receivables that have been factored and removed from the balances sheet but remain outstanding:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Sales	$3,489	$3,548	$3,951	$4,134	$3,716	$3,674	$3,553
Gross Trade Receivables	$1,260	$1,373	$1,632	$1,731	$1,664	$1,304	$1,282
Unbilled Receivables	$824	$746	$705	$831	$839	$727	$702
Allowance for Doubtful Accounts	$12	$12	$15	$16	$8	$9	$8
Net Trade + Unbilled	$2,072	$2,107	$2,322	$2,546	$2,495	$2,022	$1,976
DSO	**53.4**	**54.6**	**54.1**	**56.0**	**60.4**	**50.6**	**51.2**
Outstanding Factored Receivables	$1,577	$1,552	$1,362	$1,589	$1,108	$1,432	$1,270
Factored DSO	**40.7**	**40.2**	**31.7**	**35.0**	**26.8**	**35.9**	**32.9**
Adjusted Receivables	$3,649	$3,659	$3,684	$4,135	$3,603	$3,454	$3,246
Adjusted DSO	94.1	94.9	85.8	91.0	87.3	86.5	84.1

Points to note:

- We noted in our review of the 12/22 quarter that a huge sequential increase in outstanding factored receivables resulted in an 8.5-day sequential increase in adjusted DSOs. In the 3/23 quarter, balance sheet DSOs fell by 1.2 days sequentially and 7.0 days YOY. However, this was more than offset by a 13.9-day jump in factored DSOs.

- On the positive side, factored DSOs only rose by 0.8 days sequentially illustrating that the rate of factoring did not accelerate meaningfully. Also, adjusted DSOs fell which reduces the concern that sales were pulled into the quarter with more favorable payment terms.

- If revenues grow in the back half of the year, receivables should increase. We will be watching to see if the company chooses to accelerate factoring in the second quarter. BALL does not disclose the cost of factoring quarterly, but we know this source of liquidity is becoming more expensive.

Perrigo Company plc (PRGO)
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

PRGO reported non-GAAP EPS of 45 cps in the 3/23 quarter which was 2 cps above the Street estimate. However, the adjusted tax rate fell to 19.5% from 22.5% in the year-ago period. The 2023 tax rate guidance was 21.5% going into the quarter, which implies that over a penny per share of the beat could have been the result of the tax rate falling below what analysts had modeled.

The turnaround story remains in play with several areas investors should be keeping a close eye on:

- ***In the first quarter of 2023, PRGO's inventory DSIs increased by over 12 days compared to the previous year and nearly 5 days sequentially.*** However, analyzing PRGOs inventory is complicated by a myriad of factors. When comparing to pre-Covid levels, one must consider that DSIs were inflated by about 15-20 days by removing the divested RX segment as of 12/20. PRGO has also faced challenges in replenishing inventories in the infant formula, oral care, and cough and cold product categories due to factors such as increased demand, supply constraints, and disruptions caused by the pandemic. While the company is still struggling to catch up in certain categories, it has also likely incurred additional costs which are now capitalized in the company's FIFO inventories and have yet to be expensed. We are not currently alarmed by inventory levels as price increases should help offset the higher costs. Our concern will increase if we don't see inventory levels level off in the second half. ***(See below for details)***

- ***There have been significant movements in the final allocation of the purchase price of HRA Pharma.*** PRGO acquired HRA for $1.9 billion on 4/29/22. They have not yet finalized the allocation of the purchase price, resulting in quarterly adjustments to the accounts based on new information. There was an $81 million increase in goodwill in the 3/23 quarter driven by a $104 million reduction of definite-lived intangibles. This would have resulted in a reduction in amortization although the company adds back amortization to non-GAAP results so this would not have impacted adjusted results. However, we never take an increase in goodwill and a decline in definite-lived intangibles as a positive sign given goodwill's less substantial nature. ***(See below for details)***

- ***The 3/23 reduction in goodwill was preceded by the 12/22 quarter's $70 million reduction in goodwill and indefinite-lived intangibles*** driven by a $69 million increase in definite-lived intangibles and an $11 million increase in inventories. The increase in definite-lived intangibles would increase amortization which again is not relevant to non-GAAP results. However, the increase in inventory likely benefitted the cost of sales which we estimate could have been as much as a 6 cps benefit to earnings. ***(See below for details)***

- ***The company's estimated useful lives used to calculate amortization related to the HRA deal appear to be quite long.*** PRGO uses estimated useful lives of 20 years for trade names, 8-18 years for developed technologies, and 2-21 years for distribution networks. We consider the high ends of these ranges to be relatively long compared to those used by companies with similar assets which could arguably result in insufficient amortization charges. However, as with the purchase price allocation changes, the fact that the company adds back amortization to non-GAAP results makes this irrelevant for non-GAAP EPS. ***(See below for details)***

- ***The company incurred $0.05 per share in costs associated with inventories returned from HRA's distributors related to the new distribution initiatives.*** In addition, the company incurred costs associated with a voluntary recall in infant nutrition related to new FDA guidelines. Together, these items were a 130 bps headwind to gross margin. Management had already announced the HRA distribution impact in 3/22 and it expects the impact in the next two quarters to be similar to the first.

- ***The company resolved the 2019 Athena tax*** overhang with no payment required which eliminates what had been a potential $843 million contingency.

- ***Management clarified on the call that 80% of the changes it hopes to push through with product specialization for customers in its efforts to rationalize SKUs and simplify production are non-customer-facing changes*** such as minimal changes to label size rather than major changes to bottle appearance or pill count. The first two years of the plan will involve such minor changes which should make it more likely customers will go along.

- ***Subsequent to the end of the quarter, the FDA Joint Advisory Committee voted in favor of PRGO's Opill*** which bodes well for its eventual approval which the company still expects by year-end. This would be the first oral contraceptive approved for OTC use and would likely mean considerable upside. We believe the market expects this to happen but any earlier-than-expected approval would likely mean considerable upside for the stock.

Inventory Still Rising

In 1Q 23, DSIs jumped by more than 12 days YOY and almost 5 days sequentially as shown in the table below:

	4/1/2023	12/31/2022	10/01/2022	7/2/2022
Total Inventory	$1,183.0	$1,150.3	$1,085.2	$1,079.6
Cost of Products Sold	$767.9	$772.6	$737.3	$749.6
DSI	140.2	135.5	133.9	131.1

	4/2/2022	12/31/2021	10/02/2021	7/3/2021
Total Inventory	$1,022.4	$1,020.2	$1,092.5	$1,115.9
Cost of Products Sold	$736.7	$742.6	$706.3	$632.1
DSI	127.7	123.6	140.8	160.7

	4/3/2021	12/31/2020*	9/26/2020	6/27/2020
Total Inventory	$1,136.1	$1,059.4	$1,100.7	$1,034.7
Cost of Products Sold	$641.6	$668.8	$633.3	$601.6
DSI	164.7	152.1	127.5	120.0

	3/28/2020	12/31/2019	9/28/2019	6/29/2019
Total Inventory	$930.8	$967.3	$990.5	$940.5
Cost of Products Sold	$689.6	$841.9	$778.3	$718.2
DSI	95.5	108.0	115.8	119.2

	3/30/2019	12/31/2018	9/29/2018	6/30/2018
Total Inventory	$912.9	$878.0	$885.3	$883.8
Cost of Products Sold	$725.7	$752.2	$708.3	$715.4
DSI	112.0	108.6	113.7	112.4

To compare PRGO's current DSI level to its pre-Covid level, we have to adjust for the now-divested RX segment which was classified as a discontinued operation in the 12/20 quarter. The RX segment reported lower DSIs which pulled the total company's DSI down relative to the quarters where its results had been removed from COGS and inventory. We estimate that one should add 15-20 days to the pre-Covid DSIs when comparing the current DSI to long-term trends. That makes the current inventory levels of 135-140 days look slightly high compared with the 2018-2019 DSIs of 108-112. Much of this is likely due to higher costs and supply chain inefficiencies. However, more recent developments in key product areas have also complicated the analysis of DSI trends in the last year. These include:

1. Infant formula inventories: In early 2022, Perrigo experienced unusual demand due to a competitor recall in the infant formula market. This surge in demand stretched the company's manufacturing capacity and depleted its inventories. In addition, the FDA

issued new guidelines for the production of infant formula which required PRGO to perform plant sanitizations and implement longer quality holds, which further affected inventory replenishment. This situation has extended the timeline for PRGO to achieve a safety stock position in the nutrition business. Management now believes it could be the end of the year before formula supplies return to normal.

2. Oral care product inventories: Perrigo faced limitations in its oral care product inventories due to supply constraints from China. However, management has indicated that the situation has improved and it has made progress in replenishing oral care inventories.

3. Cough and cold inventories: PRGO has been playing catch-up with cough and cold inventories for several quarters. The demand for cough and cold products experienced a significant decline during the COVID-19 pandemic as lockdowns essentially eliminated the 2020 cold and flu season. Retailers initially did not anticipate the surge in demand in 2022 which resulted from the return of a more typical cold and flu season. This led to grossly insufficient orders and a flood of late-season orders from retailers trying to restock. PRGO struggled to keep up with the sudden increase in demand, causing its inventories to fall behind which restricted sales. The company is still rebuilding the safety stock of these inventories and expects to be in a good position for the next flu season. This has impacted the sequential movements in inventory and uses of cash.

4. In the 4/1/2023 quarter, PRGO's inventory levels were impacted by the integration plan with HRA Pharma. The company had to increase inventory to accommodate the taking back of inventory from HRA distributors as part of the integration process. We don't know the exact amount of inventory taken back in the first quarter, but the company stated in the conference call "***there's an approximate $32 million onetime impact to operating income in 2023 associated with returning inventory from distributors. Of this annual estimate, $12 million top line*** and $0.05 in EPS impacted the first quarter as expected." At a 40% gross margin rate, a $12 million top-line impact implies about $7 million in inventory which was returned. This would have added only about half a day to inventory assuming cost of sales was credited as a part of the adjustment.

All of these factors have left PRGO struggling to rebuild inventory throughout 2022 in the cough and cold, infant nutrition, and oral care categories. Despite the narrative sounding as if the company is low on inventory, rising costs and inefficiencies have also driven up the dollar value of inventory. Management contends it will take until the second half to be back to normal in cough and cold and infant nutrition. We are not overly concerned by inventory levels yet, but will become more concerned if the rise in DSI continues into the second half of the year.

It is important to note that PRGO uses FIFO accounting for inventories and it turns its inventories relatively slowly. This means that the inventory balances still have higher costs baked in related to the nutrition shakeup and the struggle to keep up with the demand for cough and cold. Gross margin showed 400 bps improvement in the first quarter courtesy of strong price/mix despite and130 bps combined headwind from a voluntary recall in nutrition and the HRA inventory transition. The improvement is expected to continue throughout the year. However, these higher costs capitalized in inventory will continue to be a headwind for margin expansion over the next couple of quarters.

Purchase Price Allocation

PRGO acquired HRA Pharma on 4/29/22 for $1.9 billion. It has yet to finalize the allocation of the purchased price among the asset and liability accounts which results in adjustments to the accounts each quarter based on new information the company obtains that impacts it assumptions used in the valuation. The following table shows a breakdown of the movements in each account over the last three quarters and the original allocations made at the end of Q2 22:

	3/23 Quarter	12/22 Quarter	9/22 Quarter	Initial Valuation
Goodwill	$80.6	-$58.6	$1.9	$616.2
Indefinite-Lived Intangibles		-$10.6		$63.3
Definite-Lived Intangibles	-$104.3	$68.7		$1,324.8
Inventories		$11.0	-$1.2	$38.5
Accrued Income Taxes		-$4.6		na
Deferred Tax Liabilities	-$27.2	$15.1	$1.1	$168.8
Other Liabilities			$0.7	na
Accounts Payable			-$1.1	$490.4
Other Non-Current Liabilities	$2.0			na
Prepaid and Other Assets	-$1.5			na
Cost of Sales	$3.5	$10.2		
Selling		$1.4		

There are several points to take away from the table above:

- In general, an increase in the original value of goodwill should be viewed as a negative as it is essentially a plug number that increases when the value of a more "real" asset has been marked down. Also, goodwill and indefinite-lived intangibles are not amortized whereas definite-lived intangibles result in expenses on the income statement. Keep in mind though, that PRGO adds back amortization of intangibles to its non-GAAP results. While we believe doing so greatly reduces the quality of non-GAAP earnings, does mean that non-GAAP earnings are not impacted by a shift in value from amortized assets to non-amortized assets.

- PRGO's disclosure does not give any detail on the cost of sales or selling expense adjustments shown above, not even the direction. The company records the bulk of its amortization in COGS so we assume that the $3.5 million cost of sales adjustment in the 3/23 quarter was a reduction in expense related to the decrease in amortizable intangibles. The $10.2 million cost of sales adjustment in the 12/22 quarter could have also been a reduction in cost of sales related to the increase in inventory offset by an increase in amortizable assets. While the portion from increased amortization would have been added back to non-GAAP results, the benefit from increased inventory would not have. Note that $10 million is approximately 6 cps.

- On the subject of amortization, the company uses estimated useful lives of 20 years for trade names, 8-18 years for developed technologies, and 2-21 years for distribution networks to calculate amortization related to the HRA deal. We consider the high ends of these ranges to be relatively long compared to those used by companies with similar assets which would result in insufficient amortization charges. However, as with the purchase price allocation changes, the fact that the company adds back amortization to non-GAAP results makes this irrelevant for non-GAAP EPS.

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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