BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

Companies in this Issue

Becton, Dickinson and Company (BDX)
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

BDX beat the consensus adjusted EPS target for the 3/23 quarter by 10 cps. The company raised the mid-point of its guidance for the full year ended 9/23 by 1.5 cps. This included an increase in the estimated negative FX impact of 5 cps and an increase in the expected impact of lost Covid test income of 5 cps. This implies an increase in the estimated performance of the base business of 11.5 cps. However, about 5 cps of that came from the company cutting the midpoint of its estimated tax rate for the full year by 40 bps. The company admitted that the second quarter rate was lower than it anticipated due to the timing of discrete factors. Despite the beat and the headline increase in outlook, the market reacted negatively, bidding the stock down 5% on the earnings release and another 5% since then.

While receivables levels showed improvement in the quarter, given the acceleration in factoring and the likely headwind to cash flow growth it will pose in the second half, we are leaving the company on our On-Deck Risk list for now.

- In our review of the 12/22 quarter, we warned that the company's accounts receivable adjusted for factored receivables that remained outstanding jumped materially versus sales both YOY and sequentially. We also noted that the pace of factoring increased in the 9/22 quarter.

- In the 3/23 quarter, DSOs adjusted for factored receivables that remained outstanding jumped to 51.7 in the 3/23 quarter which was 3.6 days above the year-ago quarter. However, DSO declined sequentially by 0.4 so the pace of the increase has slowed and reduced concern that the company pulled sales into the 3/23 quarter at the expense of the next. ***(See below for details)***

- However, the pace of factoring remained high as factored but outstanding days jumped to 6.7 vs 6.3 in the previous quarter and 4.5 a year ago. Cash from operations has received a \$400-\$600 million YOY boost from the expansion of factoring over the last three quarters. Absent a huge acceleration in factoring which is unlikely given the rise in interest rates, the cash flow tailwind will be gone after the 6/23 quarter. ***(See below for details)***

- Inventory was essentially flat sequentially which brought DSI down by 10.5 days. This is in line with the company's narrative that it is working down inventory which contains higher cost layers. Management noted on the call that it carries about 5 months of inventory so the second half should benefit once these higher cost layers have burned off.

- Prepaid expenses declined sequentially by \$100 million in the quarter. While still elevated, our concern that earnings artificially benefitted in the quarter by increased capitalization is reduced.

- We again note that we believe the company's practice of adding back amortization of intangibles to non-GAAP results paints an unrealistic picture of earnings given that tuck-in acquisitions are a key part of its growth strategy which means it is essentially acquiring much of its R&D.

Receivables Levels Improved but Factoring Accelerated

The following table shows the calculation of adjusted DSOs for the last 7 quarters:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Sales	$4,821	$4,586	$4,761	$4,641	$4,750	$4,995	$4,849
Balance Sheet Receivables	$2,413	$2,282	$2,191	$2,218	$2,303	$2,177	$2,350
B/S Receivable DSOs	45.0	45.8	42.3	43.5	43.6	40.1	44.6
Factored but Outstanding	$359	$314	$323	$215	$237	$155	$118
Transferred DSOs	6.7	6.3	6.2	4.2	4.5	2.9	2.2
Adjusted DSOs	51.7	52.1	48.6	47.7	48.1	43.0	46.8

Points to note:

- In our review of the 12/22 quarter, we warned that the company's accounts receivable adjusted for factored receivables that remained outstanding jumped materially versus sales both YOY and sequentially. We also noted that the pace of factoring increased in the 9/22 quarter.

- Adjusted DSO jumped to 51.7 in the 3/23 quarter which was 3.6 days above the year-ag0 quarter. However, DSO declined sequentially by 0.4 so the pace of the increase has slowed and reduced concern that the company pulled sales into the 3/23 quarter at the expense of the next.

- However, the pace of factoring remained high as factored but outstanding days jumped to 6.7 vs 6.3 in the previous quarter and 4.5 a year ago. The company also discloses the amount of receivables shown below:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022
Quarterly Receivables Transferred	$750	$740	$565	$216

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Quarterly Receivables Transferred	$291	$143	$118	$215

- We can see the company continues to increase the amount of receivables factored under the program which is provided a $400-$600 million in YOY boost to cash flow growth in the last three quarters. Absent a huge acceleration in factoring which is unlikely given the rise in interest rates, the cash flow tailwind will be gone after the 6/23 quarter.

Cloudflare, Inc. (NET)
Earnings Quality Update

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

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

Summary

NET's 1Q23 adjusted EPS of $0.08 was both positive (a rarity) and beat forecasts by 5 cents. It also reported positive free cash flow of $13.9 million. In both situations, we see several items that point to unsustainability. Guidance for 2023 was raised from 15-16 cents to 34-35 cents on lower revenue as well:

- NET guided to an effective tax rate of 36%. It came in at 12.4%. That was worth 2.1 cents. For 2023 guidance, the new effective tax rate is 9% which added 10 cents.

- Interest income with higher interest rates was 3.5 cents of 1Q23 adjusted EPS. That is real income, but we continue to question how many people own NET at nearly 200x forward adjusted EPS to collect interest income. It is almost half of adjusted income.

- Gross margin guidance is 75%-77%. NET came in at 77.8% and is noting that sales are taking longer to close. This added 0.8 cents.

- Cash R&D and Selling costs both increased y/y and sequentially but declined as a percentage of sales adding 1.0 cents and 0.6 cents to adjusted EPS.

	1Q23	4Q22	3Q22	2Q22	1Q22
Cash R&D	$51.3	$49.4	$46.4	$46.2	$40.3
% of sales	17.7%	18.0%	18.3%	19.7%	19.0%
Cash Sales/Mrk	$120.6	$113.0	$103.5	$103.9	$89.7
% of sales	41.5%	41.1%	40.8%	44.3%	42.3%

The ramp in selling and marketing is by design and looks real. We are OK with that. But another red flag is even NET admits sales were back-loaded, which it expects to continue. This could quickly become a headwind for margins. NET will be spending on both R&D and marketing as well as hiring and training new salespeople in the short term regardless of what sales turn out to be. Those should be viewed largely as planned and budgeted fixed costs for 1Q and likely 2Q with revenue as the wildcard. We can see below that receivables rose due to about $20 million in sales that came in at the end of the quarter. NET was close to having only $270 million in sales vs $290 million. That would have made cash R&D 19.0% of sales and selling & marketing 44.7% of sales – on the same $51.3 million and $120.6 million in costs. As a percentage of sales, R&D and Marketing would have been 450bp higher and total non-GAAP margin was only 6.7% for the quarter. Simply losing $20 million in sales that closed at the last minute probably would have cut the non-GAAP operating income of $19.4 million by more than $15 million.

We believe these items are worth 8 cents and combined to more than account for NET's beat. The sizeable increase in guidance to 34-35 cents of adjusted EPS for 2023 is not based on sales. NET cut sales guidance $50-$58 million. We know about 10 cents is coming from a huge drop in the expected tax rate and there is likely 14-15 cents in interest income. There remain several items to monitor:

What to Watch

- Sales growth was back-loaded and deferred revenue growth is faltering. NET is complaining of a longer sales cycle as many customers are conserving cash. It sees this continuing in 2Q and 2023. At the same time, Artificial Intelligence companies are rolling out at accelerated rates, are getting funding, and are buying security products including NET's offerings. Yet, sales growth is still showing signs of slowing. What if AI growth drops even a little?

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Sales	$290.2	$274.7	$253.9	$234.5	$212.2	$193.6	$172.3	$152.4
A/R	$179.7	$148.6	$126.9	$122.1	$125.4	$95.5	$84.7	$75.9
Def. Rev	$238.8	$218.6	$171.4	$155.8	$131.7	$116.5	$92.4	$79.8
A/R DSO	55.8	49.8	46.0	47.4	53.2	44.4	45.2	45.3
Def. Rev DSO	74.1	73.2	62.1	60.5	55.8	54.2	49.3	47.7
Retention %	117%	122%	124%	126%	127%	125%	124%	124%

- The 6-day jump in A/R was worth about $20 million in 1Q23 sales.
- Deferred revenue had a big jump in 4Q22 and leveled off. Given new orders, it still seems like it should have risen more.
- Retention above 100% is still a positive sign. The 117% just indicates that existing customers are not expanding their usage at the same rate when it was 124%.
- Guidance does not point to any of these situations improving in the near future.

- Another sign of slower sales is the contract acquisition costs. NET defers the cost of new customers and amortizes them over time. If the gap between new costs vs. amortization of older ones is rising, it should indicate faster growth. If it is narrowing, it should indicate slower growth:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Contract Aq cost	-$19.4	-$19.0	-$18.4	-$15.0	-$15.6	-$17.3	-$12.8	-$14.5
amortization	$14.1	$13.1	$11.8	$10.6	$9.7	$8.6	$7.8	$6.9
Net	-$5.3	-$5.9	-$6.6	-$4.4	-$5.9	-$8.7	-$5.0	-$7.6

- Positive Free Cash Flow is rare and the last two quarters saw some unusual items helping out that may not be sustainable. Free cash flow was $13.9 million in 1Q23 and $33.7 million in 4Q22:
  - 1Q23 saw capital spending drop to $17.5 million vs. $30-$40 million. That alone eliminates 1Q23's free cash flow.
  - Both quarters benefited from $11.8 million and $7.5 million in interest income.
  - Spending on new software also looks about $1 million light in both quarters.
  - In most quarters, deferred revenue is a $15-20 million help and accounts payable is neutral to a small headwind for a net of about $17 million in cash flow. For 1Q23,

NET had $11.6 million from higher payables and $21.9 million from higher deferred revenue for $33.5 million. For 4Q22, deferred revenue jumped $50.3 million and payables fell by $10.3 million for $40.0 million combined. Again, the excess in this area eliminates free cash flow for 1Q23 and almost for 4Q22.

- The higher receivables of a back-loaded quarter didn't help 1Q23, but NET is saying that situation is continuing.

- Stock compensation remains a key item for NET. Without it, NET seldom has positive cash from operations, would never have positive free cash flow, and would not be profitable:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Sales	$290.2	$274.7	$253.9	$234.5	$212.2	$193.6	$172.3	$152.4
Stock Comp	$61.8	$62.6	$55.9	$57.5	$41.8	$42.1	$28.0	$24.1
% of Sales	21.3%	22.8%	22.0%	24.5%	19.7%	21.7%	16.3%	15.8%
Headcount	3,394	3,217	3,181	3,063	2,751	2,439	2,240	2,050
Stk/employee	$18.2	$19.5	$17.6	$18.8	$15.2	$17.3	$12.5	$11.8

  - This can be lumpy and employees had lower stock comp in 1Q23. It still posted 8 cents of adjusted EPS by adding back 19 cents in stock compensation. Adjusted operating margin is about 6%. To get there, NET is adding back stock compensation of more than 21% of sales and acquired intangible amortization of 2% of sales.

  - Stock compensation per employee has leveled off of late. It is worth monitoring this to see if NET needs to pay more cash wages and less stock as sales rise. That would effectively crimp adjusted margins. Every 100bp is worth about 1 cent per quarter in adjusted EPS.

  - The Area 1 employees are still underwater with stock options that are exercisable at $93. It's been over a year for them.

  - Remember the long-term forecast calls for a 20% adjusted operating margin. NET is at 6% now. The forecast calls for 100-200bp in lower gross margin and flat cash R&D as a percentage of sales. So NET needs to pick up 1600bp by leveraging cash selling and general costs. Selling costs are rising with more employees. We will agree that cash G&A costs should leverage, but they are only 12% of sales. NET can't reach its target if G&A

went to zero. We still believe NET will need stock compensation to rise as a percentage of sales.

Stanley Black & Decker (SWK)
Earnings Quality Update

We are maintaining our earnings quality rating of SWK at 3- (Minor Concern).

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

Summary

We recently did a much larger update on SWK and urge readers to continue focusing on that March report. There is some progress being seen at SWK but we believe this may be more of a late 2023 and 2024 story. We are keeping SWK on our On Deck Value list for now, but given that EPS of $8-$9 is possible without SWK even returning to normal, this may be something to start watching more closely.

Adjusted 1Q23 EPS of -$0.41 beat forecasts by 33 cents. The market obviously expected nothing and to beat handily while the y/y decline was from $2.10 to -$0.41 shows that. Regarding earnings quality, we noted the following:

- The warranty accrual dropped again adding 1.0 cent.
- Bad debt expense dropped y/y from $11.1 million to $2.1 million adding 4.8 cents.
- Stock Comp was up $4.4 million – costing 2.4 cents.
- Pension costs were up $4.6 million – costing 2.5 cents.
- Losses on selling receivables due to higher interest rates cost 0.4 cents.
- SWK did refinance some commercial paper with $750 million in bonds at 6.00-6.27%. That will hurt EPS going forward.

From our last report, we saw three primary issues that are slowly correcting. There should be some solid margin expansion potential as these issues change:

What to Watch

- Inventory fell by $201 million, which is a positive. However, finished goods were flat and DSOs were up because 1Q is seasonally slower than 4Q.

SWK Inv.	4/1/23	12/31/22	10/1/22	7/2/22	4/2/22	1/1/22	10/2/21
Finished Product	$3,472	$3,461	$3,840	$4,115	$4,023	$3,486	$2,777
Work in Progress	$260	$339	$357	$456	$429	$395	$350
Raw Materials	$1,928	$2,062	$2,150	$2,065	$1,816	$1,539	$1,007
Total Inventory	$5,660	$5,861	$6,347	$6,636	$6,268	$5,420	$4,134
DSI Finished	102.0	97.4	112.7	117.5	116.5	111.1	98.6
DSI Wrk Progress	7.6	9.5	10.5	13	12.4	12.6	12.4
DSI Raw Mat	56.7	58.0	63.1	59.0	52.6	49.1	35.7
Total DSI	**166.3**	**164.9**	**186.3**	**189.5**	**181.5**	**172.8**	**146.7**

  - On the call, SWK noted that customers are still destocking – but the level of SWK inventory to be impacted is more manageable now. It believes retailer destocking should end in 2023.
  - SWK is also in the process of eliminating 60,000 SKUs. The first 15,000 are largely done and were in small supply. The remaining 45,000 are not to be manufactured so that may be a negative issue for reducing raw materials. It may also be a negative for selling other finished goods if those SKUs need to be cleared from store shelves first.
  - SWK reduced Inventory by $775 million from the 2Q22 peak to 4Q22. The goal in 2023 is another $750 million to $1 billion with $200 million achieved in 1Q. That goal still requires some work this year.

- It is tough to clear inventory when there are still lower volumes being sold overall. The lower Cost of Goods Sold makes the DSI ratio for Inventory levels decline. That's why DSI rose last quarter.

SWK Vol.	4/1/23	12/31/22	10/1/22	7/2/22	4/2/22	1/1/22	10/2/21
Overall	-11%	-10%	-10%	-13%	-6%	-8%	8%
Tools/Outdoor	-13%	-12%	-12%	-16%	-6%	-8%	11%
Industrial	-2%	1%	5%	4%	-5%	-9%	-1%

- SWK did note that April sales are picking up after a poor March.
- SWK continues to forecast poor sales for the rest of 2023. – calling for a lower demand outlook than the 2nd half of 2022.

- Margins have turned up a bit in the last quarter. That is the first positive change so far. The goal is still to return to a 35% margin – which has been achieved:

SWK Margin	4/1/23	12/31/22	10/1/22	7/2/22	4/2/22	1/1/22	10/2/21
Adj Gross Margin	23.1%	19.5%	24.7%	27.9%	31.3%	29.0%	32.3%
Ad SG&A %	20.5%	18.3%	18.4%	18.7%	19.8%	20.1%	20.0%

- As it clears inventory, SWK is running production levels below normal levels. It's selling more product than it replaces. This is a 400-500bp headwind. SWK is forecasting the curtailment will last all of 2Q23. Under a downside scenario, it could last through 4Q23.
- SWK does use LIFO accounting for its US operations (about two-thirds of sales). As the company burns through more inventory built after the commodity inflation as it lowers total stocks – it should be burning through those more expensive LIFO layers. That should be negatively impacting gross margins in the near term.
- The cost-cutting measure in terms of fewer employees, better supply chain processes, and lower costs are expected to be at a $1 billion run rate by the end of 2023 with $430 million achieved after 1Q23. On sales of $16-$17 billion – that's 600bp of margin helping run rate by the end of 4Q23.

- For 2023 – it is all about timing. How long does it take to clear inventory and restart normal production? The goal now is 3Q, but it could stretch to the end of 4Q. Also, are the $1 billion in near-term cost reductions complete? Those two issues are 1000 bps of margin gain going into 2024. Even at $16 billion in sales and assuming $120 million of additional interest expense – that would add $7.50-$8.00 into EPS going forward. 4Q22 was -$0.10, 1Q23 was -$0.41, 2Q23 is forecast at $0.35. For a $75 stock, adding $8 into forecasts before year-end could be a game changer.

Explanation of EQ Rating Scale

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

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

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

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

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

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

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

Key Points to Understand About the EQ Score

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

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

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