BEHIND
THE NUMBERS
Quality of Earnings Analysis
June 7 , 2023

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Behind the Numbers

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Agilent Technologies, Inc. (A)
Earnings Quality Update

We are downgrading our earnings quality rating of A to 3- (Minor Concern)

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

A reported non-GAAP EPS of $1.27 which was 1 cps ahead of the consensus estimates. Revenue came in about $40 million higher than the Street estimate and ahead of management's internal expectations. However, management reduced core revenue growth guidance for the year ended October to 3.0%-4.5% from its previous 5.5-6.5% range and EPS to $5.60-$5.65 versus the previous $5.65-$5.70. Management stated that the more conservative outlook reflects the impact that the banking sector has had on customers' plans to spend on instrument-related capex with a special emphasis made on early-stage biotech customers.

We noticed multiple minor, non-operational benefits in the quarter without which the company would have missed. While receivables improved sequentially, DSOs remain elevated compared to a year ago and the company once again cited orders at the end of the quarter as the reason for the elevated numbers. All this prompts us to reduce our earnings quality rating to 3- (Minor

Concern) although we note that the lowered guidance and the stock price decline may have removed much of the downside risk from an earnings miss in the back half of the year.

- We mentioned in our review of the 12/22 quarter that DSOs had been rising for several quarters and the company had highlighted "higher shipments near the end of the quarter" and the higher cash conversion cycle of its growing nucleic acid business as reasons. While DSOs for both trade and unbilled receivables remain elevated versus a year ago, trade receivable DSOs fell sequentially by more than 4 days and unbilled receivables days fell by about half a day sequentially. However, the company's explanation for the YOY increase in receivables in the 10-Q changed to include only "higher shipments near the end of the quarter." This is the second straight quarter where this was given as a reason for higher DSOs and the mention of the nucleic acid business collection cycle dropped out. We view this as somewhat concerning as it could be a sign that the company has been relying on offering better terms to pull sales into the current quarter at the expense of the next. We also note that the stock price decline was a result of lowered guidance and the company noting more cautious customers. ***(See below for details)***

- Other income (expense) contained a loss on equity securities of $4 million versus a loss of $16 million in the year-ago quarter. This swing added over 3 cps to EPS growth in the quarter.

- Interest income rose to $12 million in the quarter versus $9 million in the previous quarter and $1 million in the year-ago period. Management specifically said on the call that interest income was higher than planned due to higher interest rates and strong cash flow. Just the $3 million in incremental interest income compared to the previous quarter represents almost a penny per share.

- Accruals for new warranties fell by $2 million despite an increase in sales. We estimate that this added almost a penny per share to EPS.

- Lower stock-based compensation added almost a penny per share to EPS.

Receivables Declined but Remain Elevated

The following table shows the calculation of days sales of trade receivables as well as unbilled receivables for the last eight quarters:

	4/30/2023	1/31/2023	10/31/2022	7/31/2022
Trade Receivables	$1,401	$1,459	$1,405	$1,345
Net Revenue	$1,717	$1,756	$1,849	$1,718
Trade Receivables Days of Sales	72.6	76.4	69.9	72.0
Unbilled Receivables	$262	$276	$275	$273
Unbilled Receivables Days of Sales	13.6	14.5	13.7	14.6

	4/30/2022	1/31/2022	10/31/2021	7/31/2021
Trade Receivables	$1,237	$1,205	$1,172	$1,122
Net Revenue	$1,607	$1,674	$1,660	$1,586
Trade Receivables Days of Sales	68.5	66.2	65.0	65.1
Unbilled Receivables	$247	$207	$197	$182
Unbilled Receivables Days of Sales	13.7	11.4	10.9	10.6

Points to note:

- We mentioned in our review of the 12/22 quarter that DSOs had been rising for several quarters and the company had highlighted “higher shipments near the end of the quarter” and the higher cash conversion cycle of its growing nucleic acid business as reasons.

- While DSOs for both trade and unbilled receivables remain elevated versus a year ago, trade receivable DSOs fell sequentially by more than 4 days and unbilled receivables days fell by about half a day sequentially.

- However, the company’s explanation for the YOY increase in receivables in the 10-Q changed to only include “higher shipments near the end of the quarter.” This is the second straight quarter where this was given as a reason for higher DSOs and the mention of the nucleic acid business collection cycle dropped out. We view this as somewhat concerning as it could be a sign that the company has been relying on offering better terms to pull sales into the current quarter at the expense of the next. We also note that the stock price

decline was a result of lowered guidance and the company noting more cautious customers.

Paychex, Inc. (PAYX)
Earnings Quality Update

We are lowering our earnings quality rating of PAYX to 5- (Strong).

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

Summary

PAYX routinely beats forecasts and the adjustments to EPS are tame. PAYX removes excess tax benefits from stock compensation because it is lumpy and not controlled by the company. Removing this results in lower adjusted EPS than GAAP. Otherwise, adjustments are legitimately one-time in nature and are small:

	YTD 2023	YTD 2022	fiscal 22	fiscal 21	fiscal 20	fiscal 19
GAAP EPS	$3.33	$3.02	$3.84	$3.03	$3.04	$2.86
excess tax benefits	-$0.02	-$0.05	-$0.05	-$0.05	-$0.04	-$0.02
R&D Tax credit		-$0.02	-$0.02			
Restructuring				$0.07		
Adj. EPS	$3.31	$2.95	$3.77	$3.04	$3.00	$2.84

For the quarters so far in fiscal 2023, PAYX has reported $1.29 (beat by 5 cents), $0.99 (beat by 3 cents), and $1.03 (beat by 6 cents). The biggest change of note is that higher interest rates have boosted interest income. Also, PAYX uses a short and accelerated amortization period for acquired intangibles. Both depreciation and amortization are declining y/y:

- The February 2023 quarter beat by 5 cents. PAYX added $2.2 million from lower depreciation and $2.0 million from lower amortization – 0.5 cents and 0.4 cents respectively.

- The February 2023 quarter saw interest income increase from $14.4 million to $35.3 million. Plus interest on corporate investments rose to $14.8 million from $0.5 million. This was expected and added 4.4 cents and 3.0 cents respectively.

- The issue to quibble about is that higher rates are reducing the value of the portfolio. PAYX has a $234.6 million unrealized loss. That has grown as rates have continued to rise. That would be about 50 cents of cumulative losses. Because the portfolio is high grade and the longest maturities are only 7 years (a high percentage is 30-40 days), PAYX does not fear default risk and plans to hold these securities to maturity and not realize a loss.

- We downgraded our rating from 5+ (Strong) to 5- (Strong) because PAYX has seen some revenue growth in the last 12-18 months based on employers hiring more people and wage growth. It is seeing evidence of both situations moderating, which could become a headwind. Also, the paper losses on the portfolio will likely limit any investment gains in the near future.

- Overall, we still believe PAYX has very clean accounting and high earnings quality. Free Cash flow normally exceeds net income even with some growth causing working capital to be a small headwind. ROI is still over 50%.

What to Watch

- Capitalization of Customer Acquisition Costs still does not look troubling. These costs are amortized on an accelerated basis over 8 years. The capitalized costs are $578.9 million now or 17% of shareholder's equity. What is key for us is PAYX does not adjust this out of non-GAAP EPS as a non-cash expense as we see at other companies like Iron Mountain (IRM). Also, the new contracts are exceeding amortization indicating growth:

	Feb 23	Nov 22	Aug 22	May 22	Feb 22	Nov 21	Aug 21	May 21
Cost new Contracts	$65.2	$50.0	$57.0	$70.0	$70.1	$52.4	$46.6	$54.3
Amortization	-$48.9	-$48.0	-$46.6	-$45.6	-$44.8	-$43.8	-$42.9	-$42.2
Difference	$16.3	$2.0	$10.4	$24.4	$25.3	$8.6	$3.7	$12.1
Cost to fulfill	$8.3	$7.6	$7.5	$7.0	$7.4	$6.5	$7.1	$6.9
Amortiz	-$6.6	-$6.5	-$6.4	-$6.3	-$6.3	-$6.2	-$6.2	-$6.2
Difference	$1.7	$1.1	$1.1	$0.7	$1.1	$0.3	$0.9	$0.7
EPS Impact	$0.038	$0.011	$0.240	$0.053	$0.056	$0.019	$0.010	$0.027

If PAYX did immediate expensing of these costs, EPS would be 1-5 cents lower in various quarters. The fact that PAYX does not ignore the amortization as a non-cash cost for something that does cost cash upfront still gives them high marks on earnings quality in our view.

- We noticed that PAYX has boosted its bad debt reserves and reduced its purchased receivables of late too. The purchased receivables are bought from temporary staffing firms to enhance their operating cash flow. Any given purchase is considered small and they generally are paid within 45 days. PAYX has not had a history of seeing write-offs of any consequence. There is likely some more risk here than buying short-term muni bonds. Bad debt expense is up $13 million YTD – about a 3-cent headwind.

	Feb 23	Nov 22	Aug 22	May 22	Feb 22	Nov 21	Aug 21	May 21
Purchased Rec.	$582.0	$616.9	$596.0	$618.8	$618.5	$723.2	$480.3	$495.9
Bad Debt Reserve	$21.1	$20.4	$19.8	$18.2	$17.8	$18.0	$12.1	$16.0

- Insurance reserves for workman's compensation insurance remain something to watch. The total reseve is now $189.7 million and will be updated in the next 10-K. This again is an area where PAYX has a long history of operating. The maximum payout for an individual claim is $0.5 million. We still believe that it is a big positive for PAYX that this type of insurance renews frequently. It allows them to adjust pricing if needed. The balance sheet could absorb a larger problem here if reserves are too low, but that has not been the normal history.

Steris plc (STE)
Earnings Quality Update

We are upgrading our earnings quality rating on STE to 3+ (Minor Concern)

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

Summary

STE reported non-GAAP EPS of $2.30 which was 15 cps ahead of consensus estimates. The top line came in over $110 million ahead of targets. The Street reflected favorably on the numbers, bidding the stock up over 10% on the results.

Receivables growth came back more in line with sales which alleviates some of our concerns. We saw both positive and negative non-operational benefits and the beat remains well intact after considering all of these. These factors prompt us to raise our earnings quality rating to 3+ (Minor Concern) from 3- (Minor Concern).

- We called out a sharp sequential increase in receivables in the 12/22 quarter despite revenue falling well below expectations. The rate of increase in receivables relative to revenue moved more in line in the 3/23 quarter as DSOs declined 2 days sequentially. However, while DSOs improved sequentially, receivables overall remain somewhat elevated. Management indicated on the call that high receivables remain a drag on cash flow as it has yet to collect on receivables generated in its seasonably high fourth quarter. ***(See below for details)***

- Despite the strong growth in revenues, deferred revenue fell sequentially and YOY which caused deferred revenue days to fall by more than 2 days YOY. Also, backlog and remaining performance obligation fell relative to sales. Typically, declines in deferred revenue and backlog should be viewed as negative indicators for future revenue growth or possibly an indication of aggressive revenue recognition. However, this concern is mostly alleviated by management's discussion of supply chain bottlenecks clearing and allowing for delivery of delayed orders. ***(See below for details)***

- We discussed in our review of the 12/22 quarter that the company noticeably raised its allowance for doubtful accounts percentage. We estimated this was a 1.4 cps headwind to earnings growth in the 12/22 quarter and pointed out it was setting up the company for a potential non-operational benefit from reversing the allowance in a future period. This seems to have occurred in the 3/23 period as the allowance fell despite a more than $100 million sequential increase in receivables. We estimate this could have added about 4 cps to earnings in the quarter. ***(See below for details)***

- Similar to the company's unusual shoring up of accounts receivable reserves in the 12/22 quarter, the company has been building up the reserve for obsolete and slow-moving inventory over the last few quarters. The jump in the reserve percentage seems unusual given that STE is supposedly moving inventory that has been delayed by supply chain backups. We estimate the increase in the reserve percentage shaved about 2.7 cps off of earnings in the period. Analysts should be watching for any unusual boost to earnings in the upcoming quarters coming from a material reduction in the inventory reserve. ***(See below for details)***

- We noted that the 12/22 quarter benefitted from a sharp YOY decline in the provision for warranty expense. This more than reversed in the 3/23 quarter which was penalized by a difficult comp with the 3/22 quarter which benefitted from a small warranty credit. We estimate this was an approximate 4 cps headwind in the period. ***(See below for details)***

DSOs Improved

We called out a sharp sequential increase in receivables in the 12/22 quarter despite revenue falling well below expectations. The rate of increase in receivables relative to revenue moved more in line in the 3/23 quarter as DSOs declined 2 days sequentially as shown in the following table:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022
Revenues	$1,385	$1,216	$1,201	$1,156
Accounts Receivable	$928	$823	$780	$764
Accounts Receivable Days of Sales	60.3	62.2	59.8	60.1

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Revenues	$1,211	$1,209	$1,197	$968
Accounts Receivable	$799	$752	$762	$743
Accounts Receivable Days of Sales	59.4	57.2	58.6	69.9

While DSOs improved sequentially, receivables overall remain somewhat elevated. Management indicated on the call that high receivables remain a drag on cash flow as it has yet to collect on receivables generated in its seasonably high fourth quarter:

> *"This year, we were under significant pressure from a free cash flow standpoint on both our receivables increased because just the timing of the revenue, a big bulk of our revenue is in Q4. So we were unable to collect. So that will push into FY '24."*

As we will discuss in the next section, the company's deferred revenue declined relative to sales as did backlog and RPO which management indicated is due to supply chain backlogs freeing up and allowing it to fulfill orders that had been delayed. This is a positive development and the elevated receivables level is consistent with this narrative. We expect to see receivables DSOs continue to moderate as the fiscal year moves along.

Deferred Revenue Dropped

The following table shows the calculation of deferred revenue days of sales.

	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Deferred Revenue	$92.283	$100.232	$98.224	$100.617	$110.791	$106.329	$106.247
Revenues	$1,384.837	$1,215.994	$1,200.517	$1,156.491	$1,210.686	$1,208.971	$1,196.985
Deferred Revenue Days of Sales	6.0	7.6	7.5	7.9	8.2	8.1	8.2

Points to note:

- Despite the strong growth in revenues, deferred revenue fell sequentially and YOY which caused deferred revenue days to fall more than 2 days YOY.

- Management indicated that supply chain bottlenecks have freed up which has allowed it to deliver equipment for which delivery had been delayed. This resulted in a decline in backlog and remaining performance obligation (RPO) relative to sales seen in the following two tables:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Revenues	$1,384.837	$1,215.994	$1,200.517	$1,156.491	$1,210.686	$1,208.971	$1,196.985
RPO	$1,553.461	$1,592.000	$1,561.000	$1,574.000	$1,546.000	$1,570.000	$1,374.000
RPO Days	101.0	120.4	119.6	123.9	114.9	119.5	105.6

	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Healthcare Backlog	$494.700	$540.360	$553.121	$521.676	$423.643	$381.601	$311.240
Total Healthcare Revenue	$884.648	$769.144	$732.813	$698.526	$738.841	$759.675	$744.134
Healthcare Backlog Days of Sales	50.3	64.6	69.4	68.0	51.6	46.2	38.5
Life Sciences Backlog	$104.900	$110.623	$99.457	$92.706	$104.693	$117.235	$98.263
Total Life Sciences Revenue	$157.456	$121.273	$125.768	$132.207	$143.258	$127.908	$132.327
Life Sciences Backlog Days of Sales	60.0	83.9	72.8	63.8	65.8	84.3	68.3

- Typically, declines in deferred revenue and backlog should be viewed as negative indicators for future revenue growth or possibly an indication of aggressive revenue recognition. However, this concern is mostly alleviated by management's discussion of supply chain bottlenecks clearing and allowing for delivery of delayed orders.

- Inventory was essentially flat sequentially in the quarter after several quarters of increases. DSIs were down 2.4 days YOY and 13.4 days sequentially which confirms management's narrative.

Allowance for Doubtful Accounts Fell

We noted in our review of the 12/22 quarter that the company noticeably raised its allowance for doubtful accounts percentage. We estimated this was a 1.4 cps headwind to earnings growth in the 12/22 quarter and pointed out it was setting up the company for a potential non-operational benefit from reversing the allowance in a future period. This seems to have occurred in the 3/23 period as the allowance fell despite a more than $100 million sequential increase in receivables:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Net Receivables	$928.315	$822.758	$780.113	$763.788	$799.041	$752.132	$762.003
Allowance for Doubtful Accounts	$23.427	$25.137	$22.196	$24.371	$24.371	$21.120	$17.657
Gross Receivables	$951.742	$847.895	$802.309	$788.159	$823.412	$773.252	$779.660
Allowance % of Gross Receivables	2.5%	3.0%	2.8%	3.1%	3.0%	2.7%	2.3%

We estimate this could have added about 4 cps to earnings in the quarter.

Inventory Reserve Increasing

Similar to its unusual shoring up of accounts receivable reserves in the 12/22 quarter, the company has been building up the reserve for obsolete and slow-moving inventory the last few quarters as shown below:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Gross Inventory	$741.075	$736.245	$685.112	$659.829	$605.936	$622.228	$586.295
Inventory Reserve	$45.582	$41.888	$40.176	$39.425	$30.937	$27.629	$21.763
Reserve % of Gross Inventory	6.2%	5.7%	5.9%	6.0%	5.1%	4.4%	3.7%

We note that net inventory which shows up on the balance sheet was virtually flat sequentially but this was almost entirely due to the increase in the inventory reserve. The sequential increase

in the inventory reserve is less than half a day of inventory so the company is not masking a building in net inventory by increasing the reserve.

However, the jump in the reserve percentage seems unusual given that STE is supposedly moving inventory that has been delayed by supply chain backups. We estimate the increase in the reserve percentage shaved about 2.7 cps off of earnings in the period. Analysts should be watching for any unusual boost to earnings in the upcoming quarters coming from a material reduction in the inventory reserve.

Warranty Expense Increased

We noted in our last review that the 12/22 quarter benefitted from a sharp YOY decline in the provision for warranty expense. This more than reversed in the 3/23 quarter which was penalized by a difficult comp with the 3/22 quarter which benefitted from a small warranty credit as shown below:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Quarterly Warranties Issued	$4.519	$2.545	$2.919	$3.285	-$0.264	$4.808	$4.497
Quarterly Settlements made	-$4.278	-$2.893	-$2.572	-$3.950	$0.373	-$4.225	-$4.714
Ending Balance	$13.683	$13.442	$13.790	$13.443	$14.108	$13.999	$13.416

We estimate this was an approximate 4 cps headwind in the period.

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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