BEHIND
THE NUMBERS
Quality of Earnings Analysis
August 4, 2023

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Behind the Numbers

Companies in this Issue

AT&T Inc. (T)	p. 1
Altria Group, Inc. (MO)	p. 8
Cintas Corporation (CTAS)	p.11
Mohawk Industries, Inc. (MHK)	p.13
United Rentals, Inc. (URI)	p.20
WESCO International (WCC)	p.23

AT&T Inc. (T)
Earnings Quality Update

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

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

Summary

AT&T's adjusted 2Q23 EPS of $0.63 beat forecasts by 3 cents. The only adjustments were adding back its share of DirecTV amortization of 3 cents and removing an actuarial gain on pensions for 1 cent. It also affirmed guidance for 3% adjusted EBITDA growth, Free Cash Flow > $16 billion, and Adjusted EPS of $2.35-$2.45.

- There were several interest expense-related headwinds – AT&T had guided to some interest headwinds coming into the year.
  - Capitalized interest due to spectrum being put into service dropped from $358 million to $265 million y/y which cost AT&T 1 cent of EPS.
  - Securitization fees rose by $76 million – an 0.8-cent headwind.
  - Pension income fell to $111 million from $257 million – a 1.6-cent headwind, with $99 million due to higher interest rates.
- Retiring the first set of mobility preferred shares reduced the fully-diluted share count. Some of this was expected, but the 4Q22 plan was to retire the shares over three years. AT&T completed the retirement in April of 2023, by issuing non-convertible preferred shares in April and June. The fully-diluted share count dropped from 7,611 million to 7,180 million in 2Q23. That added 3.5 cents to EPS and one-third of it happened in 4Q22. That was a known event expected to happen by 4Q24. Likely just over 1 cent of this EPS was unexpected in the 2Q.
- Free cash flow forecasts continue to be affirmed by AT&T at $16+ billion for 2023. It has reported $5.2 billion for the 1H23. We are comfortable with the forecast because a few of the major cash flow drains from 1Q are easy to see the timing, and won't recur. These include:
  - $4.5 billion in 4Q device payments for phones, that were paid in 1Q23.
  - $1.0 billion of 2022 bonuses that were paid in 1Q23.
  - The capital spending forecast of $24 billion for 2023 was front-loaded, so $12.4 billion in 1Q and 2Q should be closer to $11.5 billion in 3Q and 4Q – down about $1 billion.
  - AT&T knows the DirecTV distribution was $1.0 billion in 1H23 and will be $0.5 billion in 2H23.

    - AT&T sees $1 billion more in cash taxes for 3Q and 4Q, but sees that being offset by lower working capital. That may include additional receivable securitization, but primarily is related to capitalized customer acquisition costs where cash that was paid upfront will now amortize as non-cash expenses. The amortization is running about $180 million per quarter over 2022 levels and AT&T is saying that amortization should exceed cash payments for new sign-ups in 2H23.

- AT&T needs $11 billion in the second half of 2023 to reach its target. We know that cash from operations in the first half of 2023 was $16.6 billion, which was penalized by the larger level of device payments and bonuses paid. Just adding that item back gets 6 months of cash flow to $22.1 billion. The DirecTV payment makes it $22.6 billion. Subtract $11.5 billion in expected Cap-Ex – and free cash flow is $11.1 billion for the second half and AT&T hits its forecast. It still has some growth coming with new customers, higher prices, and more cost-cutting. That gives a cushion if the tax bill exceeds working capital decreases.

Altria Group, Inc. (MO)
Earnings Quality Update

We are maintaining our earnings quality rating of MO at 2- (Weak) and leaving it on our Focus Risk List.

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

Summary

MO's 2Q23 adjusted EPS of $1.31 beat forecasts by 1 cent. MO has a history of beating by 1 cent, which is suspicious and makes even a minor earnings quality issue or sustainability questions into large risks for earnings. After cutting guidance in June by 10 cents to reflect the NJOY acquisition, MO held guidance after 2Q results. We see several items that are low-quality or unsustainable in 2Q adjusted EPS:

- The only adjustment was adding back 12 cents for litigation costs. We have pointed out that MO has lived in court for decades and litigation is a way of life here. Management is pointing out that 10 cents of this is related to their JUUL settlement which may be a one-time event. The other 2 cents of litigation and accrued interest penalties is enough to make the quarter a miss on its own.

- Last year in 2Q22, MO had a $12 million loss on its ABI investment and a $120 million loss on Cronos. It added back $112 million of writing off Russian/Ukraine business for ABI and $107 million for equity losses at Cronos in adjusted earnings. Apples-to-apples, MO gained 0.7 cents on these investments in 2Q23's EPS.

- In selling its share of the IQOS business to PM, MO booked $26 million in interest income on PM's receiveable that has since been collected. That added 1.1 cents to EPS in 2Q23 and will not recur. At the same time, the interest cost on pensions is rising with interest rates and is a 1.6-cent headwind.

- MO used its first payment from PM to fund share repurchases. It used the last payment in July to retire the NJOY debt. The lower share count gave MO 1.8 cents in EPS in 2Q.

The problem is it does not have the cash flow to continue buying back shares. The dividend was $3.36 billion in the first half of 2023 and free cash flow was $3.0 billion. Plus, we know smoking income is 87% of segment earnings and is not growing.

- Marketing, General, and Administrative expense adjusted from the litigation costs rose from $515 million to $562 million in 2Q23. That's a 2-cent drag and was impacted by some transaction costs for NJOY. But, MO only owned NJOY for 1-month. It is forecasting a 10-cent hit from NJOY for the second half of 2023 as it tries to boost distribution and likely marketing for the product.

- On the call, there was some optimism that the decay rate for cigarette volumes moderated by 1%. We do not see a reason to be optimistic. It was down 10% on top of a -10% last year and the industry showed only a -7.5% decay rate. MO is complaining about discount cigarettes taking share, competitors are still offering menthol and flavored cigarettes in California taking share. And, even with lower gasoline prices – the compounding of cigarette prices hurts demand and even MO now notes that people going back to work makes it tougher to smoke as frequently.

Smoking Vol Decay	4Q	3Q	2Q	1Q
2023			-10.0%	-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%

- Pricing on cigarettes rose by $488 million but that was more than offset by -$542 million in lost volume. MO also noted that pricing was hurt by rising promotional spending. We think the company is already reaching the stage where revenue growth is negative and it is accelerating volume losses by trying to offset that with pricing. If pricing gains were only lower by only 1%, it would have cost MO 5 cents in quarterly EPS.

- We noted previously that *Skoal* is in a tailspin too and there are considerable intangible assets there.

Skoal Vol.	4Q	3Q	2Q	1Q
2023			-9.2%	-8.2%
2022	-11.7%	-5.0%	-10.3%	-8.9%
2021	-4.1%	-8.8%	-2.4%	-6.0%
2020	-4.3%	-6.1%	-7.9%	2.0%
2019	-5.3%	-6.7%	-2.7%	-8.5%

Coph Vol.	4Q	3Q	2Q	1Q
2023			-6.7%	-5.4%
2022	-11.3%	-2.6%	-8.2%	-6.3%
2021	-1.7%	-7.4%	-3.5%	-1.7%
2020	-1.3%	-3.0%	4.7%	-0.2%
2019	-3.3%	-0.4%	-3.9%	0.6%

There is $5.1 billion in goodwill for these units and $9.1 billion in other intangibles – that includes $3.9 billion for the *Skoal* trademark. In December, MO determined that the value of *Skoal's* trademark exceed the $3.9 billion by 12% - but if the discount rate used was 100bp higher, it would exceed by only 2% or $78 million. Volume decay has offset the pricing gains MO has taken for this unit as adjusted income has declined. Some of that is being offset by *on!* sales. MO said it will not review this for impairment until 4Q.

Oral Income	4Q	3Q	2Q	1Q
2023			$443	$416
2022	$370	$425	$430	$407
2021	$390	$405	$472	$429
2020	$412	$440	$456	$416
2019	$395	$442	$422	$367

- We will also point out that the accounting for NJOY is aggressive in our view. The deal cost $2.9 billion. $1.6 billion was assigned to goodwill and will not be expensed. Another $1.4 billion is assigned to intangibles and will be expensed over 13-18 years. The goodwill alone will save MO about 0.6 cents per quarter (using a 40-year amortization period). Does the developed tech here with a valuation of $1 billion really have a 13 to 18-year life? Over 5 years this would be a 2.1-cent quarterly drag, at 15 years it's only 0.7 cents.

Cintas Corporation (CTAS)
Earnings Quality Update

We are maintaining our earnings quality rating of CTAS of 3- (Minor Concern) and leaving it on our On-Deck Risk List.

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

CTAS reported EPS of $3.33 which beat the consensus estimate by 14 cps. However, we continue to see concerns with the quality of the company's reported earnings.

- Inventory reserves remained elevated. While the allowance came down sequentially, the allowance as a percentage of gross inventory increased slightly and remains well above the pre-Covid level of 8-9%. We believe the elevated level of the reserve could have created an earnings "cookie jar" which can benefit earnings by either reversing the existing reserve or simply reserving less than normal for new purchases. For perspective, every 1% of inventory that the reserve comes down represents approximately 4.5 cps in earnings. Analysts should be monitoring future quarters for takedowns of the reserves. ***(See below for details)***

- Growth from the rapid expansion of First Aid margins is ending. First Aid margins are still rising rapidly YOY, jumping by almost 500 bps and we estimate that this accounted for 10 cps of the 52 cps in earnings growth in the quarter for a segment that accounts for only 10% of sales. Some of this has been due to lower-margin PPE sales dropping out of the mix compared to a year ago. However, First Aid margins declined sequentially and will be up against much tougher comparisons in the next quarter. The margin simply leveling off will eliminate a key source of recent growth. However, keep in mind that the current level of First Aid gross margin of over 50% is about 200 bps above the pre-Covid norm. We are skeptical that the company can maintain those levels which would mean a drain on earnings if those margins revert to past levels at all. ***(See below for details)***

- CTAS does not disclose detail on pricing, but management has indicated that price increases have been running above the pre-Covid norm. With costs coming down and

the economy showing signs of weakness, pricing returning to normal will cut a key source of recent growth.

Inventory Reserve Remains Elevated

We have been following how the company raised its allowance for obsolete inventory immediately after Covid to reflect the falling value of PPE equipment it purchased during the pandemic. However, as the following table shows, while the allowance has come down some, it remains well above the pre-Covid norm of 9%:

	5/31/2023	2/28/2023	11/30/2022	8/31/2022
Total Net Inventory	$506.604	$531.270	$514.839	$473.888
Reserve for Obsolete and Slow-Moving Inventory	$80.100	$83.000	$70.200	$89.100
Reserve % of Gross Inventory	13.7%	13.5%	12.0%	15.8%
	05/31/2022	2/28/2022	11/30/2021	8/31/2021
Total Net Inventory	$472.150	$486.750	$464.864	$463.692
Reserve for Obsolete and Slow-Moving Inventory	$100.300	$103.000	$106.600	$110.200
Reserve % of Gross Inventory	17.5%	17.5%	18.7%	19.2%
	5/31/2021	2/28/2021	11/30/2020	8/31/2020
Total Net Inventory	$481.797	$533.211	$534.128	$488.165
Reserve for Obsolete and Slow-Moving Inventory	$111.000	$63.600	$52.300	$48.200
Reserve % of Gross Inventory	18.7%	10.7%	8.9%	9.0%

Points to note:

- While the allowance came down sequentially, the allowance percentage increased slightly and remains well above the pre-Covid level of 8-9%.

- We believe the elevated level of the reserve could have created an earnings “cookie jar” which can benefit earnings by either reversing the existing reserve or simply reserving less than normal for new purchases.

- For perspective, every 1% of inventory that the reserve comes down represents approximately 4.5 cps in earnings.

- Analysts should be monitoring future quarters for takedowns of the reserves.

First Aid and Safety Margins Fell Sequentially

We have highlighted in past reviews how rapid expansion in the company's First Aid and Safety Services segment had been fueling a disproportionate share of recent earnings growth. The following table shows segment gross margins for the last 16 quarters:

	5/31/2023	2/28/2023	11/30/2022	8/31/2022
Uniform Rental and Facility Services Gross Margin	47.7%	47.1%	47.0%	47.5%
First Aid and Safety Services Gross Margin	51.0%	51.6%	50.5%	49.6%
All Other(Fire Protection and Direct Uniform Sales Gross Margin	43.9%	43.9%	43.7%	44.8%
Total Gross Margin	47.7%	47.2%	47.0%	47.5%

	5/31/2022	2/28/2022	11/30/2021	8/31/2021
Uniform Rental and Facility Services Gross Margin	45.7%	46.3%	46.8%	48.3%
First Aid and Safety Services Gross Margin	46.1%	44.2%	43.5%	44.8%
All Other(Fire Protection and Direct Uniform Sales Gross Margin	44.7%	43.6%	42.8%	44.6%
Total Gross Margin	45.6%	45.8%	46.0%	47.6%

	5/31/2021	2/28/2021	11/30/2020	8/31/2020
Uniform Rental and Facility Services Gross Margin	47.7%	46.3%	47.5%	48.7%
First Aid and Safety Services Gross Margin	43.0%	43.5%	43.0%	40.2%
All Other(Fire Protection and Direct Uniform Sales Gross Margin	43.1%	41.8%	43.1%	44.1%
Total Gross Margin	46.8%	45.6%	46.7%	47.3%

	5/31/2020	2/29/2020	11/30/2019	8/31/2019
Uniform Rental and Facility Services Gross Margin	43.6%	45.8%	46.6%	47.2%
First Aid and Safety Services Gross Margin	46.1%	48.0%	48.4%	49.0%
All Other(Fire Protection and Direct Uniform Sales Gross Margin	41.4%	41.3%	41.8%	42.8%
Total Gross Margin	43.7%	45.5%	46.2%	46.9%

Points to note:

- First Aid margins are still rising rapidly YOY, jumping by almost 500 bps. We estimate that this accounted for 10 cps of the 52 cps in earnings growth in the quarter for a segment that accounts for only 10% of sales. Some of this has been due to lower-margin PPE sales dropping out of the mix compared to a year ago.

- However, First Aid margins declined sequentially and will be up against much tougher comparisons in the next quarter. The margin simply leveling off will eliminate a key source of recent growth. Moreover, keep in mind that the current level of First Aid gross margin of over 50% is about 200 bps above the pre-Covid norm. We are skeptical that the company can maintain those levels which would mean a drain on earnings if those margins revert to past levels at all.

Mohawk Industries, Inc. (MHK)
Earnings Quality Update

We are maintaining our earnings quality rating of MHK of 2- (Weak) and leaving it on our Focus Risk List.

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

Summary

MHK reported second-quarter EPS of $2.76, 11 cps ahead of consensus estimates. However, we continue to see quality concerns with the reported earnings that cast doubt on the beat.

- Despite a sequential increase in receivables, the allowances for discounts, claims, and doubtful accounts dropped which we estimate could have added about 8 cps to earnings. ***(See below for detail.)***

- DSOs improved sequentially but still rose YOY by almost 3 days. Note that the sequential improvement could have been aided by including a full quarter of revenue from operations acquired in 1Q23. The company continued to blame customers working down their inventories as being a drain on second-quarter sales growth and indicated that trend was not over as of the end of the quarter. With three straight quarters of that type of environment, there would not be accelerating sales at the end of a quarter and we would expect the company to be focusing on collections, both of which should limit DSO growth. We continue to wonder if the company is offering generous payment terms to try to spur sales growth. Analysts should keep a close eye on receivables in the next quarter. ***(See below for detail.)***

- Amortization of contract costs expense as a percentage of the average outstanding balance was 21.7% in the 6/23 quarter. While this was 20 bps higher than the previous quarter, it was well below the year-ago level of 23.3% and remains at the low end of the historical range, which ushers in the possibility the company is utilizing a longer benefit period in its accounting assumptions which is minimizing expense. For reference, every

1% increase in the amortization percentage costs about a penny per share in earnings. ***(See below for detail.)***

- MHK incurs regular restructuring charges and discloses little detail in its SEC filings concerning the details of the plan or forecasts of how long they are expected to run. The non-GAAP add-back for restructuring charges jumped to $41 million of the non-GAAP pretax income of $219 million. This significantly reduces the quality of reported earnings in our opinion.

Allowances Dropped as Receivables Increased

Despite a sequential increase in receivables, the allowances for discounts, claims, and doubtful accounts dropped as shown in the following table:

	7/1/2023	4/1/2023	12/31/2022	10/01/2022
Gross Customer Trade Receivables	$1,970.737	$1,919.496	$1,699.130	$1,899.479
Allowance for Discounts, Claims, and Doubtful Accounts	$77.279	$81.848	$73.779	$71.742
Allowance % of Gross Receivables	3.9%	4.3%	4.3%	3.8%

	7/2/2022	4/2/2022	12/31/2021	10/2/2021
Gross Customer Trade Receivables	$2,003.358	$1,947.020	$1,721.584	$1,820.757
Allowance for Discounts, Claims, and Doubtful Accounts	$73.653	$73.214	$73.149	$78.221
Allowance % of Gross Receivables	3.7%	3.8%	4.2%	4.3%

	7/3/2021	4/3/2021	12/31/2020	9/26/2020
Gross Customer Trade Receivables	$1,861.788	$1,716.072	$1,591.503	$1,696.515
Allowance for Discounts, Claims, and Doubtful Accounts	$82.165	$86.425	$83.682	$81.851
Allowance % of Gross Receivables	4.4%	5.0%	5.3%	4.8%

	6/27/2020	3/28/2020	12/31/2019	9/28/2019
Gross Customer Trade Receivables	$1,563.110	$1,611.525	$1,491.592	$1,763.435
Allowance for Discounts, Claims, and Doubtful Accounts	$78.872	$64.745	$61.921	$70.457
Allowance % of Gross Receivables	5.0%	4.0%	4.2%	4.0%

Points to note:

- While the allowance as a percentage of gross receivables did increase by 20 bps YOY, it fell by 40 bps sequentially. While we don't know what bad debt expense was, we can estimate that it would have taken about 8 cps in provision expense to sustain the allowance percentage at 4.3%.

- As we have noted in past reviews, the allowance percentage was running in the 4.0-4.8% range in 2018-2019 before Covid. With the economy weakening, we would expect the mid-to-high-4% range to be a more appropriate level, not for the allowance to be falling. This could be a material headwind to EPS growth in the next couple of quarters if the company has to increase the allowance for bad debts.

Receivables Remain Elevated

We observed in our last review that the company's accounts receivable DSOs rose YOY for the second straight quarter with the company attributing the increase in part to orders made late in the quarter. This was a concern given the fact that customers had begun trimming their inventories unexpectedly. The YOY increase in DSOs continued into 2Q23:

	7/1/2023	4/1/2023	12/31/2022	10/01/2022	7/2/2022	4/2/2022	12/31/2021
Revenue	$2,950.4	$2,806.2	$2,650.7	$2,917.5	$3,153.2	$3,015.7	$2,760.7
Gross Customer Trade Receivables	$1,970.7	$1,919.5	$1,699.1	$1,899.5	$2,003.4	$1,947.0	$1,721.6
Allowance for Discounts, Claims, and Doubtful Accts	$77.279	$81.848	$73.779	$71.742	$73.653	$73.214	$73.149
Net Customer Trade Receivables	$1,893.5	$1,837.6	$1,625.4	$1,827.7	$1,929.7	$1,873.8	$1,648.4
Trade Receivables DSOs	58.4	59.6	55.8	57.0	55.7	57.2	53.7

Points to note:

- DSOs improved sequentially but still rose YOY by almost 3 days. Note that the sequential improvement could have been aided by including a full quarter of revenue from operations acquired in 1Q23.

- The company continued to blame customers working down their inventories as being a drain on second-quarter sales growth and indicated that trend was not over as of the end of the quarter. With three straight quarters of that type of environment, there would not be accelerating sales at the end of a quarter and we would expect the company to be focusing on collections, both of which should limit DSO growth. We continue to wonder if the company is offering generous payment terms to try to spur sales growth. Analysts should keep a close eye on receivables in the next quarter.

Capitalized Contract Costs Increasing While the Amortization Percentage Remains Low

MHK capitalizes the costs of setting up new marketing and product displays in its customers' stores and amortized them over the expected period of benefit. The following table shows the ending capitalized contracts balance and the amortization expense associated with those balances for the last 16 quarters:

.

	7/1/2023	4/1/2023	12/31/2022	10/01/2022
Ending Balance Capitalized Contracts	$69.201	$63.082	$59.015	$60.457
Average Capitalized Balance During the Quarter	$66.142	$61.049	$59.736	$59.454
Amortization of Costs to Obtain Contracts	$14.380	$13.099	$17.126	$13.518
Amortization % of Average Capitalized Balance	21.7%	21.5%	28.7%	22.7%

	7/2/2022	4/2/2022	12/31/2021	10/2/2021
Ending Balance Capitalized Contracts	$58.451	$49.042	$49.644	$57.065
Average Capitalized Balance During the Quarter	$53.747	$49.343	$53.355	$57.539
Amortization of Costs to Obtain Contracts	$12.536	$12.340	$17.639	$13.846
Amortization % of Average Capitalized Balance	23.3%	25.0%	33.1%	24.1%

	7/3/2021	4/3/2021	12/31/2020	9/26/2020
Ending Balance Capitalized Contracts	$58.012	$54.544	$59.847	$62.596
Average Capitalized Balance During the Quarter	$56.278	$57.196	$61.222	$62.396
Amortization of Costs to Obtain Contracts	$14.615	$15.581	$17.091	$16.356
Amortization % of Average Capitalized Balance	26.0%	27.2%	27.9%	26.2%

	6/27/2020	3/28/2020	12/31/2019	9/28/2019
Ending Balance Capitalized Contracts	$62.196	$66.965	$69.039	$54.900
Average Capitalized Balance During the Quarter	$64.581	$68.002	$61.970	$61.400
Amortization of Costs to Obtain Contracts	$19.214	$15.540	-$0.070	$14.479
Amortization % of Average Capitalized Balance	29.8%	22.9%	-0.1%	23.6%

Points to note:

- Amortization expense as a percentage of the average outstanding balance during the quarter was 21.7% in the 6/23 quarter. While this was 20 bps higher than the previous quarter, it was well below the year-ago level and remains at the low end of the historical range.

- The amortization percentage has dropped 400-600 bps in some quarters and it appears that the company is utilizing a longer benefit period in its accounting assumptions which is minimizing expense. For reference, every 1% increase in the amortization percentage costs about a penny per share in earnings.

- Another reason that the company is unlikely to benefit from lower contract amortization is the fact that the capitalized balance is rising. As shown in the following table:

	7/1/2023	4/1/2023	12/31/2022	10/01/2022	7/2/2022	4/2/2022	12/31/2021
Beginning Balance of Capitalized Cots to Obtain Contracts	$63.082	$59.015	$60.457	$58.451	$49.042	$49.644	$57.065
Amortization of Costs to Obtain Contracts	-$14.380	-$13.099	-$17.126	-$13.518	-$12.536	-$12.340	-$17.639
Amount Capitalized (PLUG)	$20.499	$17.166	$15.684	$15.524	$21.945	$11.738	$10.218
Ending Balance Capitalized Contracts	$69.201	$63.082	$59.015	$60.457	$58.451	$49.042	$49.644
Sales	$2,950.428	$2,806.223	$2,650.675	$2,917.539	$3,153.188	$3,015.663	$2,760.737
Amounts Capitalized as % of Sales	0.69%	0.61%	0.59%	0.53%	0.70%	0.39%	0.37%

MHK does not disclose the amount of contract costs capitalized each quarter, but we can back into an estimate using the change in the balances as follows which is shown as a plug number in the above table. The amount capitalized is volatile and trends seasonally higher in the second quarter. However, we find it unusual that given falling sales led by weak demand for do-it-yourself customers and retailers that are still cutting back on their inventories that the amount being capitalized for in-store displays is rising. On the other hand, the company did mention in the call that it is launching new promotions for low-end price point products where demand is expected to be stronger. Analysts should keep an eye on the capitalized balance in upcoming quarters keeping in mind that every $1 million in capitalized costs amounts to a penny per share in earnings.

Regardless, the fact that the capitalized balance is rising should spell higher contact amortization costs in the future.

Warranty Reserve Remains at Low Levels

The following table shows the warranty reserve as a percentage of sales for the last 16 quarters:

	7/1/2023	4/1/2023	12/31/2022	10/01/2022
Revenue	$2,950.428	$2,806.223	$2,650.675	$2,917.539
Warranty Reserve	$43.065	$39.572	$38.425	$39.190
Warranty Reserve % of Sales	1.5%	1.4%	1.4%	1.3%

	7/2/2022	4/2/2022	12/31/2021	10/2/2021
Revenue	$3,153.188	$3,015.663	$2,760.737	$2,817.017
Warranty Reserve	$40.942	$41.693	$45.215	$46.346
Warranty Reserve % of Sales	1.3%	1.4%	1.6%	1.6%

	7/3/2021	4/3/2021	12/31/2020	9/26/2020
Revenue	$2,953.833	$2,669.026	$2,641.764	$2,574.870
Warranty Reserve	$54.702	$55.024	$54.692	$53.520
Warranty Reserve % of Sales	1.9%	2.1%	2.1%	2.1%

	6/27/2020	3/28/2020	12/31/2019	9/28/2019
Revenue	$2,049.800	$2,285.763	$2,424.512	$2,519.185
Warranty Reserve	$53.769	$51.983	$49.184	$46.984
Warranty Reserve % of Sales	2.6%	2.3%	2.0%	1.9%

Points to Note:

- The warranty reserve as a percentage of sales rose sequentially by 10 bps and showed its first YOY increase in years. The sequential increase in the percentage penalized EPS growth by about 1.8 cps.

- The tailwind from lower warranty expense has now reversed, but the negative effect has room to run. Before Covid, the warranty reserve typically ran almost 2% of revenues. Every 10 bps of sales that it increases costs the company about 3.5 cps in earnings. This could be a material headwind over the next couple of quarters as the company struggles to keep costs down in an environment of weak consumer sales.

United Rentals, Inc. (URI)
Earnings Quality Update

We are maintaining our earnings quality rating of URI at 4+ (Acceptable) and leaving it on our Focus Value List.

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

Summary

URI's adjusted EPS for 2Q23 of $9.88 beat forecasts by 94 cents. It also boosted guidance for revenues, EBITDA, and free cash flow (helped partially by lower capital spending). Most importantly, the margin scare from the Ahern deal appears to be improving further. The beat looks real:

- Stock compensation declined by $9 million adding 10 cents – this was flat last quarter and is normally a headwind.

- But, advertising reimbursements rose by $9 million, which erased the stock compensation by 10 cents.

- A lower share count added 30 cents. This driver of EPS growth had stalled as URI completed the Ahern deal. We think this can continue to be a tailwind. URI is free cash flow positive at almost 5x the dividend. Plus, it has been in a period of higher capital spending after Covid and supply chain issues. It was still frontloaded again for 2023 and now URI not only raised its EBITDA forecast, it reduced its net-CapEx forecast too boosting free cash flow.

- Adjustments to EPS remain consistent with past policies:

    - URI added back $0.55 in acquired asset amortization. We are not fans of this, but at least URI amortizes these quickly often over 5 years or under accelerated methods for customer relationships. It rose with the new Ahern deal. Also, the bulk

of acquired assets is still rental equipment, which is depreciated and eventually sold and replaced by URI.

- URI added back $0.30 for depreciation of acquired rental equipment. This reflects mark-ups to fair market value which has occurred with recent inflation and is netted with changes in forecasts for depreciable lives of equipment. Again, we are not fans of this, but we would rather have the acquisition assigned to PP&E and see it expensed more quickly and eventually sold than to goodwill.

- URI is already selling some of the equipment that was marked up to fair value at the time of acquisition. It added back $0.25 in 2Q23 to reflect the remaining marked-up value of the equipment sold. The turnover of equipment again tends to remove this type of acquisition accounting item more quickly than when it is assigned to intangibles and the spread between GAAP and non-GAAP narrows more quickly after the first year of the deal.

- URI added back $0.20 in restructuring. This is normally done quickly too and is mostly severance, closing overlapping rental locations, and linking remaining locations and employees into URI systems. At URI, this historically is quick – not a 5-year plan like we see at other companies. By comparison, even though URI does several deals, restructuring was zero in 2Q22. So, again the spread between GAAP and non-GAAP should narrow rapidly here.

- The Ahern deal is still progressing as planned. URI cannot change that Ahern was a lower-margin business at the time it was acquired. This business relies on trying to cut a heavy fixed cost number where possible (eliminating duplicate locations, buying equipment more cheaply, not leasing equipment) and expanding the revenue by cross-selling acquired customers. URI now has two quarters showing actual results for each company from 2022, a pro forma figure for the combined 2022 quarter, and the actual combined 2023 figure. URI is seeing the margin grow again.

Adj. EBITDA %	Combined '23 URI and Ahern	Pro forma '22 Combined	URI stand alone Actual '22	Ahern stand alone Actual '22
2Q	47.7%	46.4%	47.3%	35.6%
1Q	45.8%	44.2%	45.1%	33.0%

- Gross margin on rentals is improving too. The EBITDA figure above removes the depreciation and thus ignores the impact of marking up the acquired equipment to fair market value and boosting deprecation expense.

Rental Gross Marg.	Combined '23 URI and Ahern	Pro forma '22 Combined	URI stand-alone Actual '22	Ahern stand-alone Actual '22
2Q	39.3%	39.1%	40.7%	18.3%
1Q	36.6%	36.5%	38.3%	13.7%

URI is still underperforming its stand-alone figure by 140bp from 2Q22, but it is starting to widen the y/y change on a pro forma basis. As the marked-up equipment is sold and replaced, the gross margin should improve over time. We would note that depreciation of rental equipment rose 130bp from URI's stand-alone 2Q22 to the combined company's 2Q23. Some of the markup is in the 130bp headwind.

- Also, fleet productivity is still positive. But the rate of change is coming down against very high comps. This is worth watching. This is a measure of price hikes, time equipment is on rental, and rental mix. Having this compound has helped margins of late.

Fleet Productivity	4Q	3Q	2Q	1Q
2023			2.1%	5.9%
2022	5.9%	8.9%	11.3%	13.0%
2021	10.3%	13.5%	17.8%	-0.5%

.

WESCO International (WCC)
Earnings Quality Update

We are maintaining our earnings rating of WCC at 5- (Strong) and are keeping it on our Focus Value List

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

Summary

WCC's EPS for 2Q23 of $3.71 (down 4 cents sequentially) missed by 74 cents. Plus WCC reduced guidance due to supply chains opening further and causing inventory destocking among ESS customers. This reduction is 1%-2% of sales growth to 4%-6%, a 30-40bp reduction of EBITDA margin, and EPS of $15-$16 for 2023.

We talked last quarter about the risks of WCC and its customers over-ordering when the supply chains were not efficient which resulted in WCC's inventory surging as delayed inventory suddenly showed up in 1Q23. What we still really like about WCC is it continues to see volume growth in many areas. That is what cures too much inventory in the system. Even in areas of negative volume growth, the underlying demand is still growing, it just needs to consume inventory in the channel first. It is what separates WCC from other companies grappling with the same inventory problem but are trying to solve it amid negative demand trends.

- We noted that 1Q23 saw WCC pick up 40 cents in EPS from the tax rate coming in 18.9% vs. guidance of 27%. The 27.2% rate for 2Q23 was expected and the change sequentially cost 45 cents in EPS.

- WCC did reduce its inventory after the spike in 1Q. This is expected to continue dropping and release more cash flow. DSOs on receivables fell by a day also. Releasing working capital is helping cash flow and WCC has reduced acquisition debt. It noted on the call

that it will start to focus on both debt repayment and stock repurchases in the future – which could help EPS growth:

	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Inventories	$3,584	$3,730	$3,499	$3,490	$3,166	$2,881	$2,666	$2,570
DSIs	72.4	77.8	74.2	75.7	67.1	66.8	63.5	61.1

- Selling down the inventory occurred even with WCC claiming it did not want to sacrifice price, which likely cost it some volume. It reported that volume growth was 0% in the quarter, which was a small organic volume drop offset by cross-selling. The way the business operates is most costs for labor, storage, warehousing, transportation are largely fixed going into the period. Margin rises as more volume is run over those fixed costs. A 1% volume change impacts WCC by 16 cents in EPS. It also impacts deleveraging SG&A by 10bp. SG&A was deleveraged by 27bp in the quarter. That is where much of the earnings miss came from, over 40 cents. There was wage inflation too impacting that SG&A, so WCC probably would have hit forecasts if there had not been destocking at ESS customers in the quarter.

- Suppliers to WCC are working down inventory, WCC is working down inventory, and WCC customers are working down inventory. All three levels built up a cushion to deal with supply delays that are now unwinding. All that leads to order cancellations or slower new orders, which is messing up backlog growth figures. We don't have a figure for supplier rebates that WCC earns on a quarterly basis as it is only reported annually. Those rebates lower Cost of Goods Sold, and WCC's gross margin was down 7bp in 2Q23, costing it 6 cents in EPS. More importantly, in the inventory correction process – WCC reported that it expects a 40bp headwind from this area during the 2H23. That would be $40-$44 million in lower gross profit in 2H23, or 55-60 cents of the reduced guidance. Here is 25% of the full year's guidance cut.

- The question is when does all this normalize and will it? We think much of this will play out in 3Q and 4Q and be over. We say that because the markets are still growing and other projects are coming.

- Broadband was destocking in the quarter – but the demand is still there. Weakness there is also due to customers waiting for government funds from the infrastructure bill. That should hit in 2024 and AT&T says that also. Texas Instruments noted that it sees more government funding flowing in 2024 for the Chips Act on larger manufacturing plants.

- WCC noted that the CSS (Communications) Unit started destocking in 3Q22 and continues to post organic growth.

- Destocking means customers do not place as many new orders and backlog declines. Yet, ESS (Electrical) showed the most weakness in volumes, but backlog still rose 9%. UBS (Utility and Broadband) had some weakness in broadband volumes and backlog rose 15%. CSS with solid growth still saw destocking hurt backlog by -9%. Demand is still rising in volume terms and that speeds this transition.

- On other earnings quality items, total adjustments to non-GAAP EPS were only $15.6 million, or 30 cents which we take as a positive as that spread narrows.

- Pricing continues to be a driver of sales and we still have a concern that pricing gains could moderate in 2024 and cause some deleveraging of fixed costs. This should also be a short-lived item and would be more of a timing/transition issue where pricing from WCC to its customers declines more rapidly than the inventory it bought from supplies 60 days prior. We talked about the impact of this type of transition in the 1Q23 update.

- We will note that pricing could get a bump up in 3Q and 4Q. If WCC sees weaker volumes, it could have fewer volume rebates offered to its customers. Those are accounted for as a reduction in sales. In recent quarters, these have been 1.6%-2.2% of sales. Every 10bp they change is worth about 8 cents in quarterly EPS. There should be pressure for the rebates to decline in the near term.

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.