BEHIND THE NUMBERS
Quality of Earnings Analysis
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In this issue:

LyondellBasell Industries (LYB) Earnings Quality Update

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 LYB with a 5+ rating.

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

Summary

We are discontinuing our process of buy/sell ratings in favor of utilizing our quarterly focus list to highlight our highest conviction and timeliest long ideas and sell recommendations. As such, we are retiring our buy rating on LYB and initiating earnings quality coverage with a 5+ (Strong) rating.

LYB beat estimates handily by $0.86 as its markets are seeing a surge in demand world-wide, capacity utilization is already high, and raw material pricing remains benign and is not in short supply. LYB should see cash flow remain elevated as a result of these factors and its capital spending budget should decline. We expect working capital to build further, but there should be considerable cash flow to retire debt, support the dividend, and perhaps grow the dividend as well.

In terms of earnings quality, we consider LYB very strong. It has only one recurring non-GAAP adjustment to EPS – a non-cash charge to mark inventory values to the lower of cost or market at the end of each quarter. There have been modest integration charges after the A.Schulman deal that were not adjusted for in non-GAAP earnings nor was the impairment charge on the refinery in 3Q20. In 3Q20, LYB wrote off $582 million of the value for its Houston refinery. That was understandable for two reasons: Lower driving and flying reduced demand for gasoline and jet fuel significantly plus the refinery is set up to buy heavy crude at a discount and realize a higher margin per barrel and with less oil demand and less heavy crude, that discount level has narrowed. LYB is running the refinery. This write-off will add 3-5 cents to quarterly EPS going forward from lower depreciation. That is our largest criticism of earnings quality.

What is strong?

- Much of the working capital has been built back. We noted that in 2Q, LYB reported cash from operations of $1.3 billion but $1.4 billion came from releasing working capital. The price of raw materials plays a role here too, but we estimate that 4Q saw cash flow hit by about $0.6 billion as working capital grew on the balance sheet. Historically, receivables are $3.5 billion and currently sit at $3.4 billion while payables are normally just over $3 billion and sit at just under $3 billion now. We follow the inventories most closely and LYB has seen these rebuild also:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Inventory	$4,344	$4,005	$3,768	$3,973	$4,588	$4,446	$4,685	$4,496
COGS	$6,712	$5,885	$4,894	$6,868	$7,044	$7,269	$7,542	$7,446
DSI	59.1	62.1	70.3	52.8	59.4	55.8	56.7	55.1

- **As demand is strong, LYB is having a tough time keeping some inventory on hand. It was noted on the call that polypropylene levels are at all-time lows. We expect that working capital could remain a headwind on cash flow.** However, offsetting is rapidly rising EBITDA. Also, LYB said that price increases in January are flowing through and February may see more pricing.

Earnings and cash flow have improved rapidly post 2Q20.

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Income w/o LCM	$763	$427	$226	$495	$637	$965	$1,003	$817
Cash Opers	$743	$827	$1,292	$542	$1,242	$1,876	$1,186	$657
EBITDA	$1,266	$888	$664	$1,065	$1,205	$1,513	$1,579	$1,428

The big surge in CFO in 3Q19 and 2Q20 came from working capital being released. We could envision another $200-$300 million of headwind in 1Q21 as a result of continuing to rebuild. However, the growing inventory and accompanying increase in payables may offset much of this.

- **New investments are also expected to be lower than in past years.** LYB believes its maintenance spending is about $1 billion per year and it intends to spend another $1 billion on growth projects such as the Channelview PO/TBA plant expected to open in 2023. Thus, $2 billion in annual capital spending for 2021-23. This should lighten up cash needs for LYB considerably:

	2020	2019	2018
CapX	$1,947	$2,694	$2,105
Acquisitions	$2,472	$0	$1,776
Dividend	$1,405	$1,462	$1,554
Total	$5,824	$4,156	$5,435

Even with all the Covid problems that hurt results in 2020, LYB still posted enough cash flow to cover all its planned capital spending and dividends for 2021 without a rebound in operations that is already showing signs of beginning.

- The integration costs for the Schulman acquisition – now called Advanced Polymer Solutions – were not added back to adjusted EPS and were actually fairly minor. We give LYB high marks for earnings quality here. They also noted that they finished it. Compared to some other companies we follow where restructuring programs only seem to grow with time, it is refreshing to see one actually end.

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Integration	$0	$7	$16	$14	$38	$43	$19	$16
EPS	$0.00	$0.01	$0.03	$0.04	$0.08	$0.10	$0.04	$0.03

This is a company that was making $10-$12 in EPS per year before Covid. They were not spending a fortune on integration.

What is weak?

- The dividend is $1.4-$1.5 billion so LYB needs $3.4-$3.5 billion in cash flow to cover its needs. Last year, cash flow was impaired heavily in 1Q and 2Q – 2Q was essentially a zero if it had not released so much working capital. The results come in at $3.4 billion in cash from operations. This is compared to most years of $5.0-$5.5 billion. EBITDA is normally $6-$7 billion as well and came in at $3.9 billion in 2020. They have three units that are still underperforming. The refinery, which is the smallest part of the business, intermediates & derivatives, and technology – together, these three units were $1 billion of the lower EBITDA in 2020.

    - Technology is normally lumpy and 2020's drop of $87 million in EBITDA was largely due to not reaching revenue milestones. It seems likely to bounce back in 2021.

    - The refinery is being hurt by lower driving, less air travel, and a weak crack spread. Results here bounce around, but are normally small numbers – positive $150 million to -$100 million. We do not expect a recovery here in the near future even with higher driving as the crack spread is about half normal levels still. However, the drop of $224 million in 2020 is likely as bad as it can get.

    - Intermediates fell $714 million. A big part of this is tied to gasoline additives. Lower driving in Covid meant less gasoline usage and excess supply of these chemicals pushing down margins along with volumes. The rest of the products are basic materials for plastics and liquids like pesticides – demand there is not impaired. LYB believes this should see a bounce in 2021's 2H as the economy opens more and people return to driving. It does not require a return to air travel. From the 4Q call, *"So as driving recovers, we don't even need air travel to recover back to the original or pre-COVID levels. If driving recovers with vaccinations and more domestic travel, we could really see both Refining and Oxyfuels contribute in the second half."*

What to watch

- Several new projects are now in place that should add to results in 2021. In 3Q21, LYB spent $472 million for a 50% interest in a Chinese chemical cracker JV. This already contributed to equity income in the 4Q21. It is expected to produce $150 million in EBITDA. In 4Q21, LYB spent $2 billion for a 50% interest in a Lousiana chemical plant that is expected to add $300 million in EBITDA. In 2018, LYB bought A.Schulman which has a larger share of sales to the auto industry. The integration of that purchase is now complete and LYB is reporting it has $200 million of synergies in place that should be evident as auto production and other markets rebound. This unit saw sales fall almost $1 billion in 2020, but EBITDA only fell by $46 million. The better margins are evident in 3Q and 4Q:

APS unit	4Q20	4Q19	3Q20	3Q19
Sales	$1,108	$1,067	$1,004	$1,186
EBITDA	$152	$54	$157	$102
Margin	13.7%	5.1%	15.6%	8.6%

  The JVs should appear in equity income and it has already starting to rise with only modest contributions from the new JVs:

	4Q20	4Q19	3Q20	3Q19
Eq Income	$133	$46	$62	$51

  These areas of new earnings/cash flow growth should offset weakness in the fuel markets. These represent about $650 million in new EBITDA and the work is already done.

- Debt is elevated after the two JV acquisitions at $13.5 billion. On 2020's Covid impaired EBITDA of $3.8 billion – the debt ratio is 3.5x. The company is planning to pay down debt with excess cash flow after capital spending and the dividend. As EBITDA recovers and 4Q20 was up y/y and the awful 2Q20 is replaced, the ratio should decline too. The debt ratio is 2.4x based on 2019's non-Covid's results without JV contributions. Getting under 2x may require about $1 billion in debt reduction.

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
EBITDA	$1,266	$888	$664	$1,065	$1,205	$1,513	$1,579	$1,428

National Instruments (NATI) Earnings Quality Update

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

We are lowering our earnings quality rating on NATI to a 5- (Strong).

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

Summary

NATI's 4Q20 of 51-cents of non-GAAP EPS beat forecasts by 8-cents. It also saw revenues rebound. EPS was hurt by a higher tax rate which was a 2.5 cent headwind. EPS was helped by other income rebounding from a $2 million loss in 3Q to a $1.8 million positive income figure. That was a 2.4-cent tailwind. Overall the company's operating model of carrying high inventories worked well as it was able to take advantage of a rapid recovery in market demand.

We are moving our rating to a 5- because we see a few areas of concern regarding margins and receivable balances which we will discuss below. We still view NATI's accounting for acquisitions and restructurings to be conservative on estimated lives. Our primary negative issue is adding back recurring items to non-GAAP EPS like stock compensation and amoritization of acquired assets. In both situations, we believe these are cash expenses.

What is strong?

- **The revenue model worked as intended. Holding higher inventory balances allows NATI to capitalize on surges in demand as was seen in 4Q**. Sales rose 19% from 3Q. This also worked down the inventory balances:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Inventory	$194	$210	$210	$208	$200	$224	$231	$252
DSI	167.6	216.4	228.6	231.8	204.8	224.3	231.1	251.7

NATI was asked if there are supply constraints in the market, and management said there are some risks of that – which is why it carries high inventory levels to avoid that as much as possible. We would expect NATI to grow the inventory levels back above 200 days of sales, which should be a modest hit to cash flow. Based on guidance, that would likely mean inventory of $220 million vs. the current $194 million.

- **We believe equity-method investments saw the surge in demand as well.** NATI has a line item on the income statement of Other (Expense) Income. It is broken down as follows:

	3Q20	3Q19	thru 9/20	thru 9/10
Int. Income	$414	$1,930	$3,724	$6,187
Int. Expense	-$973	$0	-$1,115	$0
Loss Eq. Inv.	-$627	-$239	-$2,559	-$406
FX	-$676	-$378	-$2,019	-$1,623
Other	-$139	$936	-$615	$1,221
Total	-$2,001	$2,249	-$2,584	$5,379

For 4Q20, Other (Expense) Income was $1.8 million vs. -$2.0 million in 3Q20 and only $0.6 million in 4Q19. We know interest income is down due to lower interest rates and lower cash balances. We know debt is up from the OptimalPlus deal in July and that interest expense was likely flat for 4Q20 vs 3Q. It sounds like FX was a small tailwind in 4Q. We will need the 10-K to see the breakdown it but seems likely that Equity-Method Investments posted a positive income for 4Q. As noted above, the total swing was about a 2.4-cent benefit to EPS in 4Q.

- **NATI continued to invest in R&D during 2020 even amid weaker sales in 2Q and 3Q.** Only 2Q saw a drop in dollars, and this has been a drag on operating margins. As sales recover, this should leverage the spending and allow NATI to regain some margin:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
R&D $	$73.7	$70.8	$64.2	$71.6	$71.5	$66.6	$68.3	$66.2
R&D % Sales	20.0%	23.0%	21.3%	23.1%	19.4%	19.6%	20.4%	21.3%

Based on sales guidance of $325-$355 million for 1Q and an 18% tax rate, if R&D is $72-$74 million – leveraging this over higher sales could add 2-5 cents to EPS for 1Q21.

- Less software is being capitalized. That should mean more of the expense is cash and incurred in the current period going forward and less will be an amortization figure. We think this will improve earnings quality too. As noted in the last 10-Q:

> *"Due to the shorter development cycle and focus on rapid production associated with agile development, we expect that for a significant majority of our software development projects the costs incurred subsequent to the achievement of technological feasibility will be immaterial in future periods and* ***<u>we expect to record significantly less capitalized software development costs than under our historical software development approaches.</u>*** *Consequently, a larger portion of our software development expenditures are being recognized as operating expenses in the future.* ***<u>We also expect amortization of previously capitalized software development costs to steadily decline as previously capitalized software development costs become fully amortized over the next four years. "</u>***

NATI was not amortizing software over a long period and was conservative there. In 3Q, there was already essentially zero capitalized expense and the amortization was already declining from $7.1 million to $6.9 million.

What is weak?

- **Gross margin is under some pressure. There are some obvious reasons for this such as selling AWR in January 2020, which was a higher margin unit.** This accounts for about 60bp of margin compression. There was also a change in accounting policy that saw $3 million in costs that were part of operating expenses moving to Cost of Goods Sold. That is about 80bp of margin lost. Covid costs cut another 60bp off gross margin too. We know from 3Q, that OptimalPlus resulted in lower margin sales that cost about 20bp in margin too. That is 220bp of lower gross margin that is easily explained as one-time items or apples-to-oranges comps that will soon lap. The problem is non-GAAP gross margin is down 335bp in 4Q from 77.57% to 74.22% So NATI lost another 115bp in 4Q. There are some FX impacts in there that have not been quantified yet. In 3Q, before FX, NATI lost about 80bp of margin after adjusting for these other items.

  We were less concerned in 3Q as it was the first period of owning OptimalPlus. Also, sales declined y/y in 3Q by 9% and could have unwound some operating leverage. With sales rising 19% sequentially in 4Q and inventories falling, we would expect a bit more operating leverage. Also, software was a slightly larger percentage of sales and that should be help margins too.

  Keeping this in proper perspective, a gross margin above 74% is still very impressive and the AWR change will lap after 1Q. Also, a 50bp move in gross margin is worth 1-cent in EPS per quarter, so that is fairly minor for a company that just earned 51-cents. Finally, there is some cost-cutting coming that may offset this situation too as we discuss below.

- **NATI has started a new restructuring program. This one actually sounds fairly limited in scope as it will lay-off 9% of the workforce.** We think some this is aligned around the company's efforts to serve smaller customers more fully on-line as opposed to with the same labor used for larger customers. They took a $30 million charge in 4Q, which will cover this plan and it is expected to be completed within 9-12 months. There has been no estimate of what this will generate in savings. Just a rough-guesstimate – we have seen this will cover 650 employees. At at $50,000 per employee – that would reduce costs by 5-cents per quarter, at $100,000 – EPS would benefit by 10-cents per quarter. That has the potential to help on the gross margin side. It should also offset SG&A growth as travel and entertainment costs return (that has saved about $8 million per quarter with Covid – or 5-cents in EPS). We are listing this as a weakness because NATI is adding this back as a non-recuring charge as part of non-GAAP EPS. Also, they have not given much guidance on the how much savings may occur.

- **Adding back recurring charges continues as well.** As we have noted, it's one thing to spell out more detail about the cost structure by breaking more items out. It's another to treat many items as though they are not part of the cost structure at all. Also, we don't mind singling out one-time items like Covid or an impairment to explain why income rose or fell. We do mind when recurring costs that will remain recurring costs are adjusted out as non-GAAP EPS. This is something investors need to accept if owning NATI. There remains a wide-gap between GAAP and non-GAAP EPS:

	4Q20	3Q20	2Q20	1Q20	4Q19
GAAP EPS	$0.04	-$0.04	$0.08	$1.01	$0.45
Stock Comp	$0.12	$0.12	$0.09	$0.08	$0.10
Amtiz. Acq. Intangibles	$0.07	$0.06	$0.01	$0.01	$0.01
Integration/Restructring	$0.27	$0.10	$0.04	$0.07	$0.08
Amtiz Software	$0.04	$0.05	$0.04	$0.03	$0.04
Tax Impact	-$0.03	-$0.06			-$0.12
Gain on Sale	-	-	-	-$0.94	-
NonGAAP EPS	$0.51	$0.23	$0.26	$0.26	$0.56

We will agree that the gain on selling AWR in 1Q20 is a one-time item as is the $30 million restructuring charge in 4Q20 to reduce the workforce. The fact that capitalizing software is becoming less prevalent means the amount being amortized should largely vanish in the next 2-3 years and it won't penalize GAAP EPS. Before the OptimalPlus deal – adding back the amortization of acquired intangibles was a minor issue. While we applaud NATI for using reasonable amortization lives, they spent $335 million on the deal. It was clearly a cash cost they are adding back.

- Stock compensation definitely appears to be a recurring and a cash cost. Even with Covid, NATI was still repurchasing shares to limit share dilution from this process of paying people with stock. Plus, when is stock compensation going to end? This is not a one-time item. NATI still spent almost the same amount on repurchases $49 million as it reported in stock compensation in 2020 $58 million. In 2019, NATI bought $171 million in stock which more than covered the stock compensation for the several prior years combined.

What to watch

- **Were sales boosted by late quarter business and declining deferred revenue?** We are looking at this from the standpoint that Covid had impacts on results through the year and one quarter does not make a trend. Thus, we are not calling this a red-flag at the moment, but it is worth watching. DSO's bounced up in 4Q and Deferred revenue down. Both of which should have helped revenues:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Receivables	$267	$215	$212	$213	$249	$224	$223	$215
DSO	66.2	63.6	64.9	62.8	61.8	60.1	60.8	63.1

  Normally, sales and receivables rise in 4Q. Plus, in 2018, NATI often had DSOs of 65-70 days. Thus, we're not seeing 4Q's figure as a red-flag at this point. But a $52 million jump in receivables is not routine for NATI. So this bears watching.

  Deferred revenue days also decreased in the 4Q, but again it has a history of being in the ballpark of the current number of days:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Def Rev Days	41.8	44.7	44.3	44.4	41.0	41.9	44.2	47.7

  Deferred revenue actually went up in 4Q to $168 million from $151 million in 3Q. The sales were simply so depressed in 3Q that the days outstanding was higher. This is worth watching to see how it develops. This looks like a case where Covid depressed sales more than the deferred revenues are showing a red flag.

- **Sales guidance for 1Q is for $325-$355 million. That would be up 5%-15% over 1Q20. Normally, there is a seasonal drop-off from 4Q to 1Q. We are somewhat**

surprised to see a forecast that was not stronger. In 2Q and 3Q 2020 – sales fell $66 million y/y and were flat in 4Q on the rebound. It would seem there should still be more pent-up demand.

- **We also noted on the call that NATI announced it added a new distributor in January. Farnell sells electronic components and NATI said it would add NI software to its mix.** We are not certain from that note if Farnell will start selling components as well. With software, we don't worry about some initial channel stocking that may help near-term revenue. With components, we could see a small tailwind for revenue due to stocking.

Johnson Controls Intl plc (JCI) Earnings Quality Update 12/20 Qtr.

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

We maintain our earnings quality rating on JCI of 3+ (Minor Concern)

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

Summary

After the 2016 Tyco merger, JCI has been in the process of transforming itself into a pure-play building technologies and solutions provider. This has involved major divestitures including the 2016 spin-off of the Automotive Experience business, the sale of the 2017 Scott Safety business, and the 2019 sale of the Power Solutions business. Along the way, there has been a string of massive restructuring and integration charges and fixed asset write-offs. This has been the main factor for our 3 (Minor Concern Rating).

With the reshuffling largely complete, we see the company at a crossroads. The 12/20 quarter was the first in a long time that did not include a restructuring/integration non-GAAP adjustment. If this continues, the quality of overall earnings should improve and could result in an upgrade to our rating.

As far as the quarter goes, JCI reported adjusted EPS of $0.43, topping the consensus estimates by 2 cps. We identified no material one-time benefits and noted a couple of minor headwinds that could reverse in upcoming quarters.

What is weak?

- JCI has recorded multiple large restructuring charges related to various programs over the last several years which has led to the layoff of over 16,000 employees. This has been a key factor behind our 3 (Minor Concern) rating. The latest 2020 program came with a promise of removing $430 million annually from the cost structure. Divestitures, lower sales, and incremental pandemic-related costs have made it difficult to assess how well the restructurings have delivered on their promises in the near-term. We will be evaluating the progress of profitability as conditions normalize. The 12/20 quarter was the first in a long time that did not contain restructuring and integration cost non-GAAP adjustments. We view this as a positive sign and will be skeptical of any new plans that are announced.

- JCI has been buying back shares at a breakneck pace even though free cash flow has not covered the dividend and buyback for years. Proceeds from divestitures have allowed the company to do this without driving up the leverage ratio but activity will have to normalize soon which will take away a huge source of EPS growth.

What to watch

- Amortization of capitalized contract costs jumped by about 2 cps in the quarter. This headwind will likely reverse in upcoming quarters.

- Warranty accruals also jumped by about 2 cps which should reverse.

Supporting Detail

Restructuring and Impairment Charges

We have noted in the past that since the 2016 Tyco merger, JCI had been remaking itself into a pure-play building technologies and solutions provider. This has involved major divestitures including the 2016 spin-off of the Automotive Experience business, the sale of the 2017 sale of the Scott Safety business, and the 2019 sale of the Power Solutions business. All of the business reshuffling has led to a myriad of restructuring charges and impairments of long-lived assets which the company adds back to its non-GAAP results. The following table shows these charges for the last four fiscal years ended September:

FY ended September:	2020	2019	2018	2017
Net Income from Continuing Operations Attributable to JCI	$631	$1,100	$1,175	$372
Restructuring and Impairment				
Employee Severance and Termination Benefits	$196	$0	$209	$276
Long-Lived Asset Impairments	$96	$235	$42	$77
Other Restructuring Costs	$5	$0	$12	$14
Goodwill Impairment	$424	$0	$0	$0
Adj. Income from Cont. Ops Attributable to JCI	$1,352	$1,335	$1,438	$739

These charges are material and recurring. The bulk is tied to severance payments as the above restructurings included laying roughly 16,400 people and closing 9 plants. The remainder of the charges mostly consists of asset impairment charges. The 10-K does not give much detail into the restructuring actions, but the company did make some hefty promises into the eventual cost savings from each plan which are outlined below:

2020 Restructuring Plan

> *"In fiscal 2020, the Company recorded $297 million of costs resulting from the 2020 restructuring plan. The Company currently estimates that upon completion of the restructuring action, the fiscal 2020 restructuring plans will reduce annual operating costs for continuing operations by approximately $430 million. The Company expects the annual benefit of these actions will be substantially realized in 2021. For fiscal 2020, the savings, net of execution costs, were approximately 30% of the expected annual operating cost reduction. The restructuring action is expected to be substantially complete in fiscal 2021."*

> *"In fiscal 2018, the Company recorded $255 million of costs resulting from the 2018 restructuring plan. The Company currently estimates that upon completion of the restructuring action, the fiscal 2018 restructuring plan will reduce annual operating costs for continuing operations by approximately $300 million. The annual restructuring activities are substantially completed, and final payments are expected to be made in fiscal 2021."*

> *“In fiscal 2017, the Company recorded $347 million of costs resulting from the 2017 restructuring plan. The Company currently estimates that upon completion of the restructuring action, the fiscal 2017 restructuring plan will reduce annual operating costs for continuing operations by approximately $260 million. The annual restructuring activities are substantially completed, and final payments are expected to be made in fiscal 2021.”*

Given the divestitures and deleveraging of expenses from pandemic induced revenue declines and incremental expenses, it is difficult to verify if cost savings have been as much as promised. We will be revisiting that subject when conditions hopefully normalize over the next year. In the meantime, we will be very skeptical of any future restructuring and integration charges and take it as a positive that 1Q ’21 did not contain any restructuring add-backs.

Free Cash Flow Not Covering Dividend and Buyback

JCI has been able to dramatically reduce its share base over the last three years partially as a result of cash generated by divesting non-core businesses. The share count declined by 6% in FY ’19 followed by 14% in FY ’20. The following table shows cash flow statistics for the last three fiscal years:

FY Ended	9/30/2020	9/30/2019	9/30/2018
Op Cash Flow from Cont. Ops	$2,479	$1,743	$1,520
Capex from Cont. Ops	$443	$586	$645
Free Cash Flow from Cont., Ops	$2,036	$1,157	$875
Dividends	$904	$1,052	$997
Net Stock Repurchases	$2,204	$5,983	$300
Cash Flow after Buyback	-$1,072	-$5,878	-$422
Net cash for acquisitions	$77	$25	$21
Cash Flow After Buyback and Acq.	-$1,149	-$5,903	-$443

Note that the company received a $386 million tax *refund* in the 2020 period versus paying $377 million in taxes in 2019. This accounted for almost all of the reported increase in cash from operations. Normalized cash from operations is closer to $1.7 billion.

We see that the company’s free cash flow has been unable to cover the dividend and the buyback for the last three years. However, the huge shortfall from 2019 was more than covered by $12.6 billion in proceeds from the sale of its Power Solutions business. Still, JCI’s net debt to adjusted EBITDA is approximately 1.9 times. While not troubling, the company will have to normalize the buyback going forward which will limit the huge tailwind to EPS growth it has been receiving.

Capitalized Contract Costs

JCI capitalizes the incremental costs to obtain or fulfill contracts such as sales commissions and proposal costs and amortizes them over the life of the contracts. The following table shows the balance of capitalized costs and quarterly amortization expense for the last six quarters:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Current Capitalized Contract Costs	$135	$119	$121	$123	$127	$110
Long Term Capitalized Contract Costs	$101	$104	$103	$105	$109	$102
Total Capitalized Contract Costs	$236	$223	$224	$228	$236	$212
Amortization of Costs to Obtain Contracts	$41	$46	$73	$17	$26	$38

JCI does not seem to be increasing the rate of capitalizing costs as the balance is flat YOY. However, there has been a shift to short-term capitalized costs which we assume is a result of some customers looking to sign shorter-term contracts during the pandemic. This appears to be shortening the average amortization period as amortization expense jumped by $15 million in the 12/20 quarter. This was an approximate 2 cps headwind that could reverse as the company's business trends normalize through 2021.

Warranty Accruals Were Another Headwind

We also note that accruals for warranties jumped during the period as shown in the table below:

	12/31/2020	12/31/2019
Accruals for Warranties Issued During the Period	$22	$16
Accruals for Pre-Existing Warranties	$6	-$3
	$28	$13

Both accruals for warranties issued in the quarter and changes in the estimate for previously issued warranties worked against the company in the period. This would have represented another headwind of approximately 2 cps that will likely reverse in upcoming quarters.

Ball Corp. (BLL) Earnings Quality Update
Note on 12/20 Qtr. Press Release

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

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

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

What to Watch for in the 10-K

Accounts receivable DSOs fell by more than 3.5 days in the 12/20 quarter versus the year-ago quarter. We will need the 10-K to check on movements in factored receivables, but the decline could indicate that the company maintained its aggressive pace of factoring receivables to drive cash collections. The health of operating cash flow is important to track as the company presses forward with its aggressive capex spending program.

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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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.

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