BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Otis Worldwide Corporation (OTIS)
Earnings Quality Review

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

We are initiating earnings quality coverage of OTIS with a 5+ (Strong) rating.

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

Summary

We are looking at OTIS primarily because it was spun-off from United Technologies and therefore is more widely held than most people would think for an elevator company. There are two primary accounting issues people point to and we think both are very tame. The first is one unit of OTIS uses percentage-of-completion estimates to recognize revenue. With the majority of contracts being less than one year and this being a much lower margin unit – we do not see much risk in this area of pulling revenue forward and having it amount to much in EPS. The balance sheet accounts from this policy are not overly influencing cash flow either. Non-GAAP EPS looks like actual legitimate one-time items related to the separation. Restructuring charges added back are very small and we praise OTIS in that area.

Debt to EBITDA is only 2.0x and the company's goal is to continue devoting free cash flow toward debt reduction. Also, we see many potential tailwinds for earnings. Restructuring has already generated cost savings and more should be realized in 2021. The tax rate has been inflated with items from the separation and boosting tax allowances – that is forecast to decline. Bad debt reserves look likely to fall as well and there is the potential for pension assumptions to change and push down costs in that area.

What is strong?

- The basic model works well. OTIS gets about 80% of its operating income from recurring service/maintenance and modernization of existing installed elevators and escalators. Cash from operations has been a consistent $1.4-$1.5 billion and free cash flow of $1.3 billion. From that, OTIS wants to retire $250 million in debt annually, pay a dividend of 40% of EPS, which is currently a dividend of 80-cents per share or $350 million. That's before some of the cost savings OTIS is focused upon.

- The restructuring activities are expected to grow margins from 14% pre-spin-off to 20% over the coming years – roughly $650 million. Every $100 million is worth about 17-cents in EPS and 7% in EPS growth. About $70-$100 million is expected to come from supply chain changes which OTIS said in 4Q have been achieved. About $175 million will come from lower SG&A by combining office functions, streamlining computer systems, and reducing staff. OTIS has seen $40 million of saving so far and expects to complete much of this during 2021. Better digital diagnosis of maintenance issues is expected to reduce the number of visits during a repair and shorten total time also.

- What impresses us most with the restructuring is for a plan of $650 million in savings, OTIS has only spent $130 million so far. They may get to half their goal or better without spending more than $250 million and most of that will be severance.

- Percentage completion revenue recognition has been called out by the auditors as a key issue. We think the risks here are fairly low. The source of revenue recognition only impacts the new equipment unit and most sales are completed within 12-months. It is a much lower profit area so lumpy revenue or even if revenue is pulled forward – it has almost no impact on EPS. A 5% change in revenue only amounts to 3-cents in annual

EPS (2020 EPS was $2.52). The balance sheet accounts set up as part of this policy are not moving cash flow around either. Thus, we are not seeing signs of this being aggressive.

- The tax rate is higher than the 21% of the US because OTIS does considerable business in high tax areas overseas. The tax rate was 30.4% in 2020 and 34.1% in 2019. OTIS is guiding to a longer-term tax rate that will be 25-28%. That has the potential to be a tailwind for EPS growth. Every 1% of lower tax rate is worth 4-cents in EPS.

- The lower tax rate may well be possible. The adjusted rate for 2020 was 25% vs. 35% in 2019. There was a sizeable tax impact from the separation from United Tech of $137 million that should be over. Also, OTIS boosted its valuation reserve net of releases by $50 million in 2020 (12-cents in EPS) and $28 million in 2019 (6.5-cents).

- The pension assumptions are very conservative. OTIS uses a 1.05% discount rate to calculate Pension Obligations and only a 4.5% expected rate of return. The PBO is $1.23 billion and the pension is underfunded by $522 million. However, every 25bp increase in the discount rate cuts the PBO by $34 million and pension expense by $2 million – or 0.3-cents in EPS. A 100bp increase in the expected rate of return would also boost EPS by 1.2 cents more. The $1.3 billion in free cash flow already paid $60 million in pension funding.

What is weak?

- Receivables were up $365 million or 9% in 2020, DSO's were 86.4 vs. 80.1 for 4Q19. The jump looks COVID-related, DSO's peaked at 92.3 days in 1Q and 90.5 days in 2Q. This looks like an area that consumed cash in 2020 that should release some more cash in 2021.

- Bad debt expense also jumped in 2020 from $18 million to $98 million. This $70 million swing was a hit of 11-cents to EPS for 2020. Bad debt reserves were $83 million in 2019 or 2.8% but jumped to $161 million in 2020 or 4.9%. $40 million of the higher bad debt expense was ramping up reserves in light of COVIDd – that may reverse in 2021. Another $28 million of expense in 2020 was the adoption of new credit loss policies. That jump is unlikely to repeat too. Every $6 million in lower bad debt expense in 2021 is worth 1-cent in EPS.

What to watch

- Much more than the accounting, we think the bigger risks for OTIS is their new equipment sales at 43% of total revenue are heavily tied to new construction and half of them are from China. New equipment is lower margin and the goal is to lock up the more profitable service contracts for the equipment for decades. But if you want a headline risk for revenues – it is likely to be in this area.

- Foreign Exchange on earnings should also be a risk to watch. Only 27% of sales are in the US. 16% are from China and 57% from other areas of the world. The FX impact on sales has been between -3.1% to + 1% in just the last three years. That also can impact margins if OTIS needs to cut prices to compete. Plus, the tax rate has been inflated due to dealing with foreign earnings. Some of this has been higher tax rates overseas and other parts have been establishing valuation reserves on carryforwards. The foreign issues have added between 780-1390bp to the tax rate in the last three years. Divergence to that degree may be over at this point, but this is still worth being aware of. As noted above 100bp of tax rate is equal to 4-cents in EPS.

Supporting Detail

Percentage Completion Revenue Recognition Risk Looks Mild to Us

New Equipment sales form the basis for current and future revenues as service and maintenance on the installed equipment happen for decades. New equipment sales have been 42%-43% of total sales in the last three years. It is often tied to new construction projects. Customers sign a fixed-price contract with OTIS agreeing to deliver and install a complete elevator/escalator unit.

- OTIS uses the percentage of completion method to recognize revenue as the expected costs are incurred.

- OTIS says that most contracts are fulfilled within 12 months of the contract being signed – thus, this is not the longest percentage of completion process to recognize revenue.

- The company also says the revenue recognized under any method other than a fixed price is very rare.

The revenue and cost recognition process is well laid out by OTIS. The size of the various accounts and the classification of current or long-term also supports the company's statements that most contracts are completed in under 1-year.

- The customer often makes an advance payment to cover design and engineering work.

- Revenue and Cost recognition may occur before the customer can be billed under the contract. This type of revenue results in a receivable-type account called "Customer Assets."

- When customers make advance payments before the work is performed, OTIS books these payments into an account similar to deferred revenue called "Contract Liabilities."

- The net result in both cases is cash to OTIS often occurs before revenue begins being recorded.

	2020	2019	2018
New Product Sales	$5,371	$5,648	$5,596
Contract Assets	$458	$529	$657
Contract Liabilities	$2,586	$2,288	$2,359
Net Contract Liabilities	$2,128	$1,759	$1,702
Net C.L. % Sales	40%	31%	30%

Net Income + n/c items	$1,330	$1,502	$1,565
Cash from Opers.	$1,480	$1,469	$1,550
Net Chg Contract Liab.	$282	$97	$9

- In the 10-K, OTIS noted that during fiscal 2020, it recognized $1.6 billion of the $2.1 billion of Contract Liabilities on January 1, 2020. For 2019, it recognized $1.7 billion of revenue from the $1.76 billion on January 1, 2019. Covid delays during 2020 likely explain the lower revenue recognition rate last year. There were only $44 million of the Contract Liabilities listed as long-term at the end of 2020.

- Net contract liabilities are only 3-4-months of new product sales. We think that also supports the view that the percentage completion does not have much time to get that far outside the estimates.

- The difference between Income + Depreciation and one-time items vs. reported cash flow is also simply not that large. We think the revenue recognition accounting used by OTIS has a small positive impact on cash flow. We consider the policy to be tame and the policy itself is not a significant risk for results.

- If the company anticipates that a contract will see higher costs than anticipated and will result in a loss, the loss provision is recording in that period. There is also a note that some contracts are signed at a price where losses will occur (to us that sounds like a loss-leader to win the longer-term maintenance business). Those losses are recorded when the contract is signed. Both of these policies also look conservative to us.

- The only other issue is called Retainage and is basically immaterial. This occurs within receivables so the revenue has already been recognized. However, the client makes its final payment after accepting the completed project. Retainage was only $61 million at the end of 2020 and $59 million at the end of 2019.

The other reason we see the revenue recognition on new equipment as conservative is this is simply a lower-margin part of the business and much lower in terms of total income. It feeds the future revenue for service, maintenance, and modernization, which is higher-margin. Thus, the use of estimates and some timing of revenues that may be lumpy simply doesn't have the same impact on earnings:

	New Products		**Service Division**	
	2020	**2019**	**2020**	**2019**
Sales	$5,371	$5,648	$7,385	$7,470
Adj. Op. Income	$348	$402	$1,658	$1,599
Margin	6.5%	7.1%	22.5%	21.4%

Looking at this from an EPS standpoint, non-GAAP EPS was $2.52 and $2.24 for years 2020 and 2019. In both years, a loss of 1%-5% of sales of New Products only impacts EPS by 0.6 cents to 3 cents per share. This is where the percentage completion accounting is located and it simply doesn't have a material impact on EPS if sales recognition is off. For margins, it's a different story. If OTIS underbids on projects or has cost overruns – a 1% change in operating margin is 8.6-cents per share in EPS but that's not a revenue recognition issue.

Given that 2020 saw some business that was delayed as reflected in the higher contract liabilities, revenues should have a built-in tailwind for 2021. The higher contract liability balance at the end of 2020 should convert into revenues and boost income. However, as the balance drops it should be a headwind for cash flow.

The bigger risks investors should focus on for this area are new equipment sales should require new construction. That makes this more economically sensitive. Also, half the sales in this area come from China.

We will also point out that there are some capitalized costs for commissions and fulfillment that are expensed as revenue is recognized. Given that most of these new equipment contracts are completed within 12-months we do not see this as a significant risk for mismatching costs and revenues.

Restructuring and Non-GAAP Figures Do Not Appear Aggressive

When we look at the non-GAAP earnings at OTIS, the adjustments are either very minor or legitimately one time in nature. We give high marks for this:

	2020	2019
GAAP Oper. Profit	$1,639	$1,814
Separation costs	$119	$43
UTC allocated corp. cost	$16	$80
Stand Alone Costs	$0	-$147
Impairment/Loss	$85	$26
Insurance recovery	-$17	$0
Restructuring/Other	$77	$56
non-GAAP Op. Profit	$1,919	$1,872
non-GAAP margin	15.0%	14.3%

The first three adjustments relate to being spun-off from United Technologies. Those are not recurring. There remains a contractual liability of $239 million for tax agreements with Raytheon Technologies. OTIS had $85 million for a fixed asset impairment in 2020 and a $26 million loss on the disposal of a business in 2019. This really only leaves restructuring and we are surprised to see how minor this is.

Total EPS adjustments were 44-cents in 2020 with non-GAAP EPS of $2.52. Only about 13-cents looks like restructuring to us and the rest are one-time items.

The restructuring plan in full has the goal of boosting margins from 14% at the time of the spin-off to 20%. On the surface, that sounds aggressive – but OTIS points to the period 2009-15 when margins were 20%. This is expected to be driven by reducing costs and leveraging remaining costs over higher sales. On the cost-cutting here are the main targets:

- **Remove 3% from the supply chain cost.** The company spends $2.3 billion on materials and believes it can sign larger deals with fewer suppliers and achieve these savings of $70-$100 million. OTIS said on the 4Q20 call that it reached its 3% target in 2020 and it should become more evident on non-Covid sales levels.

- **Reduce SG&A by $175 million (100-150bp).** This is expected to come via reducing back office staff, consolidating office people, and upgrading computer systems. OTIS said it reached $40 million of this target in 2020 (they did not say if that is the run-rate they are now on or what they achieved in total). OTIS said in the 10-K, it expects to complete the workforce reductions in 2021.

- **Improve productivity with Internet of Things and digital monitoring equipment to both reduce the number of return visits for repairs/servicing.** This should cut labor hours on service. There is also a focus to reduce bottlenecks in production facilities too. OTIS highlighted it has over $9 billion in cost of sales where these reductions can be achieved and to hit the cost savings targets – it may only need 4% lower spending in this area.

Our conclusions are OTIS is looking to pull about $650 million out of the cost structure. That may not be completely doable in the next few years, but it sounds like they are on pace to achieve at least half of that with the supply chain and the growing SG&A cuts.

There may be some concerns about higher raw material prices, but OTIS uses FIFO accounting and inflation normally helps margins when FIFO is employed. Also, we would expect new contract prices to adjust to reflect this and mitigate some of the inflation pressure. We do expect higher R&D too. This has been 1.2% of sales ($152 million in 2020). We expect this to rise going forward.

For 2019 EPS of $2.24 as a starting point from the spin-off, every $100 million of cost OTIS can pull out of the system adds 16-cents to EPS which is 7% growth. We expect there to be more of the benign levels of restructuring spending. But the low amount spent on restructuring at OTIS is a welcome sight from so many companies reporting continual multi-billion dollar restructuring plans.

PepsiCo, Inc. (PEP)
Earnings Quality Update- 3/21 Qtr.

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 to 3- (Minor Concern) from the previous 3+ (Minor Concern)

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

Summary

PEP reported non-GAAP EPS of $1.21 in the 3/21 quarter which topped consensus estimates by 9 cps. We identified about 7 cps in unusual items so the beat remains intact. However, we are lowering our rating primarily due to the rising debt level and low dividend coverage.

What was weaker?

- The biggest unusual item in the quarter was 6 cps from an unrealized gain on a publicly-traded investment. This was recorded as a reduction to SG&A and was not adjusted out of non-GAAP results. The company even included the benefit in its definition of “core operating profit” which it cited as growing at 7%- but this falls to 2% when the $108 million pretax gain is removed. PEP also disclosed that the company has since sold the investment and will book a $30 million after-tax loss in the next quarter. We will be watching to see if the loss is adjusted out of results.

- Lower COVID-related expenses (not adjusted out of non-GAAP results) added 4 percentage points to core operating profit growth. After adjusting for that and the unrealized gain on securities, core operating profit growth fell to -2%. Management cited the negative impact of higher commodity costs of 5% and higher operating costs from supply chain issues and weather-related problems.

- Pension expense fell by 1.1 cps largely driven by the plan to freeze the company's US pension plan in 2025. This is expected to benefit 2021 by about 4 cps. This was telegraphed by the company and should have been included in analysts' models. We don't believe this be considered an unexpected part of the earnings beat.

- The tax rate came in about 30 bps lower than the 21% rate forecast for the full year due to a decrease in the tax reserve from the expiration of the statute of limitations in certain jurisdictions. This added about a penny per share.

- PEP changed the disclosure relating to its 2019 Multi-Year restructuring plan in its 3/21 quarter 10-Q. While the estimate for total cost of $2.5 billion and the cash component of $1.6 billion remained the same, the percentage of total costs expected to come from severance fell from 70% in the 9/20 Q to 65% in the 3/21 Q while the "other" component jumped to 20% from the previously estimated 15%. If the company identified that it would lay off fewer people or it would cost less to do so, why did the total cost of the plan not come down? By shifting this to the open-ended "other" category which includes the cost of implementation of the plan, it seems to us to increase the likelihood that these costs could include items such as management time that should be considered operational.

What to watch

- The company indicated in the 10-Q that favorable settlements of promotional spending accruals versus the year-ago quarter added 5 percentage points to operating profit growth. This is presumably accounted for in the impact of net pricing. Management stated in the call that it is seeing a more rational pricing and promotional environment among players in the market. Pricing has played a key role in organic growth in the last three quarters for all the company's major segments. Commodity inflation and easy comps could keep this alive for the next couple of quarters, but longer-term, consumer staples companies have a difficult time raising prices without negatively impacting volumes.

- PEP disclosed in its 12/20 10-K the existence of a voluntary supply chain finance program whereby suppliers can work with third-party institutions to receive cash payments on their receivables due from PEP. This program has apparently been in existence for a while as amounts outstanding with third parties was disclosed as being $1.2 billion at 12/20 and $1.1 billion at 12/19. The company also states that it does not expect the program to materially impact liquidity. We are not overly concerned with the program but reiterate our ongoing complaints about PEP's practice of only disclosing trade payables on an annual basis.

- We remain concerned about the fact that the dividend consumes over 80% of the company’s free cash flow and the buyback regularly consumes more than the remainder. This fact, coupled with acquisitions has led to the gradual increase in net debt to 2.8x EBITDA.

Fastenal Company (FAST)
Earnings Quality Update- 3/21 Qtr.

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

We are raising our earnings quality rating of FAST to 5+ (Strong) from the previous 4+ (Acceptable) rating.

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

Summary

FAST reported EPS of $0.37 in the 3/21 quarter, in-line with the consensus target. Our initial rating of 4 (Acceptable) was based on rising DSIs and DSOs, both of which were a reflection of a shift in mix to larger customers and a move to onsite locations. While this trend may continue to be felt somewhat in the future, the company has managed it well, and the ongoing simplicity of its reporting with no non-GAAP adjustments, strong history of returning capital via dividends (special 40 cps paid in the fourth quarter), and high 35%+ pretax return on capital warrant a 5 (Strong) rating.

Items of note in the quarter included:

- Gross margin declined by 120 bps in the 3/21 quarter. This included a $7.8 million write-down to the value of 3 ply-masks in inventory which accounted for about 55 bps of the decline. This penalized EPS by about 1.1 cps. While the company still sells these masks, a glut of supply in the market has pushed prices below a profitable level. The shift to safety products from fasteners also hit margins, but this is improving as the mix began shifting back late in the quarter. Faster growth by larger accounts pressured margins as well as the company having to purchase outside of its traditional supply chain.

- The decline in gross margin was almost offset by a 110 bps decline in SG&A as a percentage of sales. Management attributed this to the leverage of employee, occupancy, and general corporate expenses. Lower fleet maintenance expenses, reduced travel, and easier bad debt expense comps were cited. With daily sales growth of 5.3%, we are skeptical that there was this much improvement from simple leverage and many of these expenses will reverse back in upcoming quarters. However, we would expect the potential improvement in a normalizing gross margin will more than offset this. Management indicated it will raise prices in 2Q to offset expected inflation.

- Inventory DSIs fell to 152 (vs 168 last year) to the lowest level in several years. This was due consolidation of traditional branches, reduction of slow-moving inventory, and the slow signing of Onsite locations in 2020. This should reverse in upcoming quarters as the growth in activity accelerates. A one-day increase in DSI costs approximately $8 million in cash, thus getting inventory back to a more normal mid-160 DSI range could cost over $100 million in cash flow over the next couple of quarters.

- Capital spending is expected to increase to the $170-$200 million range in 2021 from the pandemic-reduced $158 million in 2020. Working capital will also likely consume more cash as inventories rebuild and receivables collections normalize.

- We note that reported EPS benefited from rounding up from 36.53 cents to 37.0. Considering the 1.1 cps unexpected mask write-off, we still view the quarter as having met expectations.

Adobe (ADBE)
Earnings Quality Update- 3/21 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 of ADBE of 4+ (Acceptable)

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

Summary

ADBE's 3/21 quarter non-GAAP EPS of $3.14 was 35 cps ahead of consensus estimates. The effective tax rate of 16% was below the forecasted 17.5% driven by a favorable tax ruling but this only added about 6 cps to EPS.

- Deferred revenue growth has been lagging revenue growth despite a shift to Cloud-based services which should result in a larger percentage of revenue being deferred. This has been influenced in the pandemic quarters as sales through its Adobe.com online channel accelerated. These sales are billed monthly rather than annually resulting in less revenue deferred. However, deferred revenue days of subscription and support revenues rose to 112 which was even with the year-ago quarter and up from 104 in the 11/20 period. We view this as a positive sign for earnings quality and future revenue trends. Continued improvement in deferred revenue could drive an upgrade in rating in future quarters.

- Capitalized costs to obtain contracts were 14.3 days of sales in the 3/21 quarter which is in the typical 14-15 days range. We continue to see no signs of aggressive capitalization and consider the company's 5-year amortization period to be reasonable.

- The company adds stock-based compensation back to non-GAAP earnings. We maintain that stock compensation should be viewed as a cash expense and believe ignoring it overstates reported results. In the case of ADBE, stock compensation amounts to 15-17% of non-GAAP operating income. While material, it is less than that the 30-40% ranges seen at peers such as Salesforce.com (CRM) and Autodesk (ADSK).

- The $1.5 billion acquisition of Workfront resulted in a $1.1 billion increase to goodwill and a $460 million increase to intangibles. The amortization periods are reasonable with 10 years for customer relationships and 3 years for technology. However, the company adds back amortization to non-GAAP results. While we believe this practice distorts adjusted earnings by ignoring the cost of deals, the impact on ADBE’s results is less than some software peers. We do note that prior to the Workfront deal, amortization was declining which was actually penalizing non-GAAP growth.

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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