BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Altria Group, Inc. (MO)
Earnings Quality Update- 3/21 Qtr. Preview

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

We are maintaining earnings quality coverage of MO with a 3- (Minor Concern) rating.

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

Summary

Altria does not report until next week and we wanted to highlight some areas where we think MO has problems and risk areas that may be discussed more when earnings are released. We see several game-changing bombs pointed at MO's operations and several of them should make an appearance during 2021. Essentially, MO was one of the larger beneficiaries of COVID. Customers worked at home where they could smoke more often and didn't need to take the

service elevator down to the loading dock to smoke in the cold or heat. No train commute, no airline travel where smoking is banned. And customers didn't buy coffee on the way to work, and they didn't drive as much so they had more disposable income. MO's 2020 was driven by volumes not shrinking at past rates and large price hikes. Those may be the quickest areas where the sales and operating income gains start to decay again in 2021. Smoking income is still what drives MO's results at 92% of operating income and the dividend is already about 80% of free cash flow.

What to watch

- The basic situation for MO is that smoking products still drive the picture here. It also covers the disastrous adventures into JUUL and Cronos which ramped up MO's debt load. Smoking is 92% of operating income and the dividend is consuming 80% of free cash flow:

MO's basic cash flow	2020	2019	2018
Operating Company Income	$10,873	$10,326	$9,115
Smoking Operating Income	$9,985	$9,009	$8,408
Percentage	92%	87%	92%
Cash from Operations	$8,385	$7,837	$8,391
Free Cash Flow	$8,154	$7,591	$8,153
Dividend	$6,290	$6,069	$5,415
Dividend pay out	77%	80%	66%
5% difference in tax rates	-$483	-$452	-$423
5% change in smoking income	-$394	-$357	-$332

  - **We believed in 2017, MO received a reprieve from cutting its dividend with the Trump tax cuts from 35% to 21%. That was worth more than $1 billion in extra cash flow per year.** The company spent it boosting the dividend further. **If rates increase by 500bp again, it would cost MO about $500 million in cash flow.** There are discussions of raising the corporate tax rate by 700-1400bp now.

  - **If the smoking income figure falls by 5%, that's another $400 million in negative cash flow swing.** We will discuss the risks of this below.

  - Investors should remember that MO is carrying much more debt than 2017 as well, Debt/EBITA is now at 2.2x adjusted 2020 EBITDA. Investors should also note that

EBITDA for that ratio was up only $176 million y/y in 2020 with smoking income up nearly $1 billion with COVID tailwinds.

  - Investors should also remember that MO's recent cash flow and EBITDA benefited from some cost-cutting and restructuring in the last two years also, that source of growth may be gone.

- **With COVID ending and people returning to work, it is unlikely that people can smoke as much going forward.** We believe 1Q represents a tough comp for cigarette volumes for MO as well. During much of COVID, many people drove less and therefore bought less gasoline. MO has been very clear that gasoline purchases eat into the smoking consumer's pocket of disposable income. **On a y/y basis, smoking will face comps where customers bought far lower volumes of gasoline produced on <$25/barrel oil with 2021 quarters where they buy more gasoline volumes produced on >$60/barrel oil.**

Y/Y Chg. Cig. Vol.	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Altria	-1.0%	-1.0%	-2.0%	-3.5%	-6.0%	-7.0%	-7.0%	-7.0%
Industry	0.5%	1.0%	0.0%	-2.0%	-4.5%	-5.5%	-6.0%	-5.0%

Historically, MO's volumes have been falling more than the industry and posting 7% declines y/y for some time coming into 2020. We believe this situation will return for 2021 with tough comps to match against. We still think smoking volumes will be cannibalized by:

  - Vaping products – which for MO are much less profitable. It only earns 35% of the net income from sales made by JUUL. That means it is trading 100% cash flow from a pack of cigarettes not being sold for a 35% of non-cash equity income from JUUL as JUUL does not pay a dividend to MO.

  - The roll-out of heated tobacco also competes against traditional cigarettes. Here the pricing is lower and MO has to split the revenue with Philip Morris. Again, that should result in lower smoking volumes and lower total cash flow. MO's argument is it will allow tobacco sales in total to decay at a slower rate, but it should hurt profitability in our view and still result in negative overall volumes.

  - **Also, MO's long-existing strategy is to offset lower volume with higher prices. In 2020, it boosted cigarette pricing by $1.15 billion or 5%. That higher pricing drove smoking operating income up by $1.13 billion vs. the net gain of $976 million.** In 2019, MO raised prices by 7% of $1.5 billion in

revenue growth and was more than 100% of the operating income gain. Now, they will raise prices as more items compete for the same dollars.

- **Higher smoking volumes by people with more time to actually smoke and more disposable income to buy cigarettes in 2020 – masked the impacts of the federal law raising the age to buy cigarettes to 21 as 2020 began.** Altria had been posting 7% declines in volume leading up to this law for several years. What is worse than that is a -7% is a net figure of lost volumes from existing smokers offset by higher volumes from new smokers. Over 95% of smokers who start – do so before age 21. Thus, we think the COVID tailwind was enormous for MO. If the normal range was -10% in smoking volumes + 3% new smokers for a -7% rate, then posting a -1% in 2020 without the +3% of new smokers is incredible. (We are using the +3% figure of new smokers just for illustration of what is happening – that figure is not quantified.). **In 2021, if existing smokers buy/smoke less due to a return to life of smoking restrictions returning to normal and coffee and gasoline purchases competing against cigarettes – and the new youth smokers aren't entering the market – it could be a sizeable drop-off in volumes against tough comps.** Remember, MO was posting -7%'s on top of -7% comps from the prior year coming into COVID without the minimum 21-year age requirement to buy cigarettes.

- **Graphic packaging continues to move forward. The FDA wants the companies to submit their plans to deal with the new graphic packaging by June 14, 2021.** The new labels are required by federal law and have been mandated in court. **They go into effect in early 2022. However, we believe there will be more news in this area throughout 2021 with the new health warnings shown on TV and newspapers.** It should start becoming part of future earnings forecasts too. Numerous studies have found the photos and larger warnings have been universally successful in getting more smokers to quit and others to smoke less. It also has been effective in preventing new smokers from starting. That has been the case in 125 countries that already have this type of packaging in place. A pack of cigarettes is something the smoker sees 20x every day and carries it around all day too. **We see this as something that will see volume decay gap down even faster and some impacts could be seen in 2021.**

- **Last week the news broke that the FDA is not going away with plans to consider eliminating menthol and cutting nicotine levels in cigarettes and there are legislative proposals for this as well. Tobacco companies demanded that any rules such as this be based on studies. We have followed this for several years now and the studies are very clear on this.**

    - Menthol is a flavoring that does not have a health issue. However, numerous studies have found that menthol masks the harshness of tobacco flavor and smoke

and enables people to smoke more often and inhale more deeply. **Menthol has also been found to help people become smokers in the first place. Many cities and states already have menthol bans in place. There are several groups asking for a federal ban at this time.** For Altria and others, menthol has frequently been their strongest volume category for cigarette sales.

- Menthol bans have been discussed it seems every 3-4 years. It has been spared as other flavorings have been banned and even e-cigarettes have seen more restrictions on flavorings. In recent years, the FDA has focused on driving people out of cigarettes as the primary goal – even if that means they use e-cigarettes instead as a less risky way to get nicotine. However, it doesn't want menthol e-cigarettes to become a gateway to smoking. This will likely take some time, but there are many bans in place already around the world and in the US. So, the movement appears headed toward a ban, but the timing is unclear.

- **The FDA also has studies that reducing nicotine from cigarettes could lead to an almost immediate 13% drop in cigarette volumes and as much as 40% over five years. This has been an issue the FDA has already been working on for many years at this point so this is not starting at step one.** The FDA has been focused on getting people out of cigarettes as the key goal. Even if they use moist snuff, e-cigarettes, gum, etc. the FDA sees cigarettes as the most harmful way to get nicotine, and discouraging their use is a big focus. At the same time, the FDA does not want new generations of nicotine users from any of those other methods.

- **We think both of these situations are game-changers on cigarette volumes. For people who think, this stuff will take years to occur, it's already been years.** Also, look at the speed at which the minimum age to buy tobacco moved to 21 and bans on e-cigarette flavors actually happened very quickly. The graphic packaging was delayed but finally ordered by courts. The last appeals only pushed it from the start of 2022 to the end of 1Q22.

- Also, as the discussion in the media turns to cigarettes, health warnings, nicotine levels, kids smoking – it may cause more smokers to quit or reduce consumption further. Thus, decay in volumes may happen before legislation or FDA bans.

The Coca-Cola Company (KO)
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 maintaining our earnings quality rating of KO of 3- (Minor Concern).

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

Summary

KO beat estimates by 5-cents in 1Q21. This was an improvement over 1Q20 as COVID issues began then. What is not quantified is KO definitely benefited from delaying marketing spending gains to normal levels. This also likely played a role in higher operating margins too. Of course, more restructuring charges were taken in the quarter also, which was 3-cents added back to the adjusted EPS of $0.55.

- Marketing is an expensive cost for KO. In 2019, it spent $4.25 billion on advertising and $4.4 billion on promotional expenses for bottlers, resellers, and customers. In 2020, it was down to $2.78 billion and $4.1 billion, respectively. That is a savings of $1.77 billion or 32-cents in annual earnings. KO does not break out these costs on a quarterly basis but said several times on the conference call that some markets have not fully returned to normal marketing levels and "We continue to reintroduce marketing spend in a targeted way." This is likely a large part of the EPS beat in our view.

- Lower marketing spending for promotional items nets against revenue so if KO spends less in that area, revenue would be higher. KO beat handily on revenue forecasts by $370 million so they likely still beat even adjusting for the lower level of promotional spending. Advertising runs through SG&A and impacts operating margin. If you want to see this process in action, look at the margin items:

KO's Adj. Rev/Margin	1Q21	1Q20	1Q19
Revenue	$9,019	$8,573	$8,698
Gross Margin	60.6%	61.6%	60.8%
SG&A Percentage	29.6%	30.9%	32.6%
Oper. Margin	31.0%	30.7%	28.2%
Operating Income	$2,794	$2,634	$2,456

If 1Q19 was normal, then revenue was reduced by higher promotional spending, but 1Q21 is 4% higher than 2019 and 5% higher than 2020. That should indicate that lower promotional spending had a meaningful benefit to revenue figures.

Also, that higher revenue figure should have leveraged cost of goods sold and gross margin should likely have risen. That's a red flag to us that gross margin is actually down in 1Q21 vs. the last two years and indicates some inflationary pressure at a minimum. Plus KO is touting its operating margin gain, but all of it came from lower SG&A where advertising expense would be and we know that is lower. 2021 will be a weird year – everyone concedes that. But we think the margin gains and revenue growth at KO may look short-lived as marketing and promotion continue to normalize.

- As we noted in the original EQ report – KO is constantly restructuring to the tune of about $500 million per year. Right on schedule, 1Q21 saw KO record $165 million of these charges again, which it promptly added back to adjusted EPS. This was 3-cents of the non-GAAP 55-cents. Our concern remains that the margin gains KO has posted for all this restructuring are minor and often less than the annual charges themselves. This is still worth following.

- There was no update on the potential $12 billion tax liability at KO. KO continues to wait on the outcome of a similar transaction pricing case involving 3M before the court will formally rule on the remaining issues for KO. That could lead to a large cash outflow if KO has to post $4.6 billion to appeal.

AT&T Inc. (T)
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 T at 4+ (Acceptable).

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

Summary

AT&T beat forecasts by 8 cents per share and it looks like a solid beat that still had headwinds in it. For example, the largest contributor of EBITDA and earnings is the mobility unit (wireless) which posted higher results even without at least $100 million (1-cent in EPS) in international roaming fees and late fees against a quarter with them. Debt-to-EBITDA rose to 3.1 times after the $23 billion spectrum purchase. However, AT&T still expects to retire debt via already announced asset sales in 2021 as well as free cash flow after dividends. The forecast is for $15 million in debt retirement and we believe the company can exceed that target.

- Mobility continued building in the quarter on FirstNet and *HBO Max* bundling. Total subscribers and connections rose 1.9% sequentially and 10.0% y/y. AT&T is taking market share at this point. Churn also remains below historical figures, which saves AT&T considerably in replacing customers. Also, the *HBO Max* bundles are driving people to premium wireless plans, which helps on revenue and ARPU too, and offsets the cost of *HBO Max* paid by the mobility unit.

- Mobility financial results looked very strong as well on EBITDA, revenue and margins:

    - Revenue was modestly higher y/y – comparing to the last pre-COVID period when there were late fees and roaming fees. Revenue rose even with ARPU down, from $55.68 to $54.10 y/y. That is largely due to the loss of roaming fees. So, there is still a tailwind coming as that business builds again that likely exceeds $200 million per quarter. AT&T is not forecasting roaming to return until late in 2021, but it will

have apples-to-apples comps in 2Q-4Q21 as those periods in 2020 had no roaming fees either.

  - Service margins also rose 100bp y/y in the quarter. That is also negatively impacted by the loss of roaming fees that are very high margin. AT&T's efforts to remove cost from the system are showing up so roaming fees should also boost margin going forward.

  - EBITDA rose 2.3% y/y. Margins were lower as equipment sales remained higher than the year before by 45%. Equipment generates EBITDA but at a much lower margin than service revenue.

  - Full 5G should carry higher revenues too and requires customers to adopt newer phones. That seems like another tailwind for revenue and EBITDA for Mobility in 2021 and beyond.

- We believe debt repayment can exceed AT&T's 2021 target of $15 billion. The forecast is for free cash flow of $26 billion and the dividend to consume $15 billion. That leaves free cash flow after the dividend of $11 billion. On top of that, asset sales already announced total $9 billion. Offsetting that $20 billion, AT&T bumped up its forecast for vendor financing payments from $2 billion to $4 billion during 2021 – that leaves $16 billion. The company did not mention additional asset sales but has said on prior calls that it would be opportunistic in selling non-core assets or monetizing real estate, cell towers, etc. Those types of deals would likely be minor, but it is possible that asset sales could exceed current guidance.

- Also looking at guidance of $26 billion in free cash flow and working backwards, AT&T is expecting basically flat free cash flow with 2020, but the moving parts are key. AT&T reports gross capital spending which includes its normal capital expenditures + vendor financing payments + FirstNet reimbursements. During 2021, it reduced the normal capital expenditures by $1 billion and boosted vendor payments by $2 billion since the initial guidance:

AT&T cash flow guidance	2021 current	2021 original	2020 actual
Capital Spending	$17.0	$18.0	$15.7
Vendor Financing Payments	$4.0	$2.0	$3.0
First Net Reimbursements	$1.0	$1.0	$1.0
Gross Capital Spending	$22.0	$21.0	$19.7
Cash Flow from Oper.	$43.0	$44.0	$43.1
Capital Spending	$17.0	$18.0	$15.7
Free Cash Flow	$26.0	$26.0	$27.4

The Cash Flow from Operations is a plug figure using the forecast for Free Cash Flow and capital spending. They are selling a large stake in the video operations. Those generated about $4.0 billion in EBITDA in 2020 and removing that accounts for much of the drop in cash flow in our view. It is $2.4 billion net of the Xandr and external advertising figures that were reported in video. AT&T is boosting vendor payments in 2021 as that helps them gain better terms in the future.

It is also important to remember that AT&T boosted cash flow from operations in 2020 by selling $2.2 billion in receivables. Adjusting for that, forecasts do not look flat.

- Based on the company's forecast for EBITDA from their debt target, they have EBITDA basically declining over $3 billion from 2020. That sounds like a very low target to us:

Debt & EBITDA Target	2021e	2020	2019
Net Debt	$154.0	$147.5	$151.0
EBITDA	$51.3	$54.5	$59.3
Debt/EBITDA	3.0	2.7	2.5

We can see the debt ratio rising because EBITDA fell during COVID in 2020. We understand selling the Video assets being a $2.4 billion headwind, but that gets AT&T to a proforma $52.2 billion in 2020. It looks very conservative to expect EBITDA to decline another $900 million in 2021:

  - WarnerMedia lost theater releases, the NCAA tournament, and other sports. It saved on content production costs, but EBITDA still fell $2.2 billion last year. This year it should get more film releases on movies already paid for. Even if it is backloaded, we would expect improvement in this unit.

  - The Xandr and advertising unit posted a flat year in 2020. It had been growing EBITDA at double-digit rates before COVID.

- The *HBO Max* roll-out was over $2 billion in 2020 starting with revenue of zero. Much of that cost hit at WarnerMedia and Mobility where EBITDA was flat last year. With HBO up 11 million domestic subscribers, AT&T noted direct-to-consumer revenues are up 35%. We know Mobility is seeing higher EBITDA and margins with the bundles. Also, AT&T noted on the call that it has stripped duplicate costs in many areas of Warner's integration and that is expected to pay for much of the HBO Max roll-out costs. If they roll out costs decline and there is revenue from the service and the cost structure is lower – doesn't that add up to higher EBITDA?

- FX has been a headwind in Mexico and Latin American operations. These are minor businesses, but other companies we follow are guiding to FX tailwind in 2021.

- Broadband also continues to grow as well. It is hard to envision wireline and business line phones falling that much more to offset all of these areas.

- We think AT&T could start to outperform this guidance. $90 million is about 1-cent in EPS. Also, the Debt to EBITDA ratio could fall under 3x without much additional effort in our view.

- Debt on a proforma EBITDA was 2.8x at the end of 2020, and the spectrum purchase of $23 billion boosted the debt. If at the end of 2021, debt reduction is $2 billion higher than forecast on flat EBITDA the ratio would be 2.9x. If EBITDA grows more this year (likely more back-loaded), it could almost reach 2.8x – the same as 2020.

The Procter & Gamble Company (PG)
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 maintaining our earnings quality rating on PG of 4+ (Acceptable).

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

Summary

PG reported non-GAAP EPS of $1.26 which was 7 cps ahead of consensus. We saw some minor one-time benefits, but the beat remains intact after adjustment.

- Other income jumped by $81 million from an unrealized gain on an equity investment that became publicly traded during the quarter. This added about 2.5 cps to earnings in the period and was not adjusted out of non-GAAP earnings.

- Accounts payable days jumped to 122 in the 3/21 period from 109 in the year-ago quarter. The company said about half that was due to extending payment terms on suppliers. Just glancing at the balance sheet, accounts payable was a $63 million cash source in the 9 months ended 3/21 compared to a $796 million use of cash in the comparable year-ago period.

- Inventory DSI jumped to 60.5 in the 3/21 quarter from 55.6 in the 3/20 quarter. Inventories were lower last year from pandemic demand but comparing this year to the 3/19 quarter's level of 57.2, inventories still look a little bit high. The company said this was a result of increasing safety stock levels during the pandemic as well as commodity cost increases. The company utilizes the FIFO method of inventory valuation and it is raising prices so we expect the higher future COGS should be offset by higher prices.

- This is the third straight quarter where PG did not add back "incremental restructuring charges" to non-GAAP earnings. As a reminder, PG always spends roughly $500 million

a year in restructuring efforts, but it only adds back charges that it considers incremental to its ongoing restructuring costs. In the 3/21 quarter, the company spent $134 million on restructuring efforts with none added back to non-GAAP EPS. In the 3/20 quarter, the company incurred $222 million in charges and added $141 million back. Looking back, there have been several quarters where PG incurred a lower level of total charges than it did in the 3/21 quarter but added material amounts back to non-GAAP results. This seemingly arbitrary adding back of expenses was the basis of our past criticism. We view the lack of restructuring add-backs as a positive to earnings quality, but analysts must review the level of charges every quarter to quantify the impact of any material YOY changes in restructuring spending.

- Free cash flow does not cover the buyback and dividend with sales of investment securities and stock option exercises covering the gap. The investment securities balance is now 0 and stock option exercise is hardly a reliable source of financing. Debt is low and the company has cash on hand to help, so the buyback is not in immediate danger of being trimmed. However, we do not see this as a sustainable capital allocation strategy, and this is the main factor keeping us from upgrading the company to a 5 (Strong).

- Over 55% of assets are comprised of goodwill and intangibles ($64 billion.) The Appliances reporting unit has a fair value well above carrying value, and the Shave Care unit's fair value exceeds its carrying value by more than 20%. However, the fair value of the Gillette intangibles ($14 billion) only "approximated" carrying value as of the 12/20 review. PG disclosed that a 25 bps decline in expected growth rate or a 25 bps increase in the discount rate would reduce the carrying value of the Gillette intangibles by 6%, or $840 million. Remember that the Shave Care unit already took an $8.3 billion write-down in the 6/19 quarter.

Supporting Detail

Buyback Is Funded by Stock Options and Sales of Securities

With the restructuring add backs gone (for now), the one item that keeps us from rating PG a 5 (Strong) is the fact that the company's buyback is not covered by cash flow after the dividend. The following table shows cash flow data for the last three fiscal years ended June:

	FY 2020	FY 2019	FY 2018
Operating Cash Flow	$17,403	$15,242	$14,687
Capex	$3,073	$3,347	$3,717
Free Cash Flow	$14,330	$11,895	$10,970
Dividend	$7,789	$7,498	$7,310
Buyback	$7,405	$5,003	$7,004
Cash Flow After Buyback	-$864	-$606	-$3,344
Sales of investment securities	$6,151	$3,628	$3,928
Impact of Stock Options and Other	$1,978	$3,324	$1,177
Cash and Equivalents	$16,181	$4,239	$2,569
Available for Sale investment Securities	$0	$6,048	$9,281

We can see that free cash flow more than covers the company's flagship dividend but regularly fails to cover the buyback as well. Keep in mind that this analysis does not take into consideration acquisitions that have totaled more than $4 billion in the periods examined. Despite this, PG's debt has not constantly risen as we see with some buyback-dependent companies. This is due to a combination of sales of investment securities and cash from the exercise of stock options. As we can see at the bottom of the table, the investment securities balance has fallen to 0, and given the volatile nature of stock option exercises, we do not view that as a high-quality source of financing to be relied upon.

PG still has cash on hand and net debt/EBITDA is still below 1x, so the buyback is not in immediate jeopardy by any means. However, this is not a sustainable capital allocation strategy.

Lamb Weston Holdings, Inc. (LW)
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 LW to 5- (Strong)

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

Summary

LW reported earnings of $0.45 per share in the 3/21 quarter which missed consensus estimates by 6 cps despite beating the top-line targets by $80 million. Sales continued to be pressured by weakness in sit-down dining traffic and costs were increased by COVID's disruption to supply chain activity plus incurring repair and maintenance costs that had been deferred since the beginning of the pandemic.

We continue to see LW's earnings as solid quality given the lack of regular non-GAAP games played by most other companies we follow. Still, we note several cents of benefits to reported earnings in the quarter that were likely unexpected by analysts' models without which the earnings miss would have been wider. This prompts us to downgrade our rating to 5- (Strong) to reflect these non-operational benefits.

- LW does not adjust out the impact of mark-to-market of currency and commodity hedges. The impact of the change in these amounts in both the company's consolidated results and the earnings of its equity affiliates added about 9 cps to earnings in the quarter.

- The effective tax rate fell to 19.8% in the 3/21 quarter from 24.3% in the year-ago period due to "discrete items". This added about 2.5 cps to the quarter.

- The year-ago $2.6 million loss from a pension withdrawal included in equity earnings results added another 1.5 cps to earnings growth in the quarter. The company discloses this well so we would not consider this an unusual benefit to earnings in the period.

- Inventory DSIs fell by 5 days from the year-ago level. Remember that the company held on to last year's potato crop longer than normal to save cash which resulted in higher costs to process the inventory that drove up cost of sales in the previous quarter. While he company is working towards more efficient inventory management in the future, it warned in the quarter that it continues to see significant supply chain disruption, some of which is already baked into inventories and will hit the income statement in the 5/21 quarter. Management stated on the call:

  "With respect to costs, in the fourth quarter, we expect to incur a similar level of incremental pandemic-related manufacturing and distribution costs as we did in the third quarter. We experienced significant disruption in our production facilities, transportation, and warehousing networks in January and February, and this continued into March. We will realize some of the costs related to these disruptions in the fourth quarter as we ship finished goods' inventory produced during these months."

- Note that the company increased its percentage ownership in its Russian JV in December from 36% to 75% which resulted in these results being consolidated rather than reported as equity earnings. While the company does not quantify the impact, it likely contributed to the adjusted decline in equity results.

Snap-on Inc. (SNA)
Earnings Quality Update

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 SNA of 4+ (Acceptable)

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

Summary

SNA reported EPS of $3.50 in the 3/21 quarter which was 40 cps ahead of consensus targets with revenue surpassing the hurdle by more than $90 million.

We saw no meaningful quality issues with the quarter. Revenue rose by more than 20% with organic growth of 16.3%. All three segments posted strong organic growth and higher than pre-pandemic levels.

- Despite the 25% organic revenue growth in the Tools segment and 8% organic growth in Repair Systems segment, credit originations rose by just 2.4%. This raised some alarm on the call as credit originations have been used by some as a proxy of sales from franchisees to mechanics and repair shops. (Remember that company automotive tool-related revenue represents sales to franchisees, not to end-users.) However, management indicated in the call that the volume of sales to franchisees approximated franchisee sales to end-users and that the disparity between organic growth and originations is a result of customers utilizing cash for a bigger percentage of purchases. This may be at least in part due to stimulus payments putting more cash in the hands of mechanics and small shop owners. If this is the case, this could be a short-to-medium term positive for future demand as customers have unused borrowing capacity to help fuel future purchases.

- Credit metrics continue to improve as past-due contracts receivables fell to 0.37% of the total while past due finance receivables fell to 2.27%, the lowest in years (except for the

June 2020 quarter in which management offering credit deferral for some customers in the pandemic.) Meanwhile, the allowance percentage was 1.9% for contract receivables and 4.4% for finance receivables, both above pre-pandemic levels. Note that lower provision expense boosted EPS by about 10 cps but we assume much of this was anticipated by analysts' models. With reserves still at somewhat elevated levels, we will be watching for any unusual takedowns going forward which could materially boost earnings.

- Inventory days of sales ended the quarter at 130 days compared to 160 in the year-ago quarter and 142 in the 3/19 quarter. If management's assessment that there is not a buildup of inventory at franchisees is correct and demand from end-user remains strong, the company will have to spend cash to rebuild inventories. Note that every one-day increase in DSI takes about $6 million in cash.

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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