BEHIND THE NUMBERS
Quality of Earnings Analysis
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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.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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