BEHIND THE NUMBERS
Quality of Earnings Analysis
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BTN Thursday Thoughts

Updates and New Developments on Active BTN Ideas

Companies covered in this issue:

Air Lease Corp (AL)

Update on 3/22 results and 10-Q review

We are maintaining our earnings quality coverage of AL at 4+ (Acceptable) and maintaining Top Buy rating

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

Summary

Air Lease's non-GAAP EPS of $1.76 in 1Q22 beat forecasts by 37 cents and it beat on revenues by $46 million. It recovered some of the Russian planes, but AL concluded it would not recover the remaining planes and wrote off the rest of the fleet there. All planes from Ukraine are accounted for at this point:

- Writing off Russian planes was a pre-tax charge of $802.4 million, which AL added back to adjusted earnings. The company also adds back income taxes for adjusted EPS. We can see that as a one-time event and it primarily lowered book value by $5.37 (at the low end of our forecast) from 4Q21 to $55.93, but had no impact on the adjusted EPS.

- When the planes were written off, the customers forfeited their security deposits and maintenance reserves of $59.6 million. That was booked into revenue and likely had little if any cost associated with it. That added 52 cents to EPS. That was not adjusted out of non-GAAP EPS and it will not repeat. We're not giving AL credit for beating on EPS or revenue based on this event.

- Stock compensation was a $2.5 million credit for 1Q22 or 2 cents of GAAP EPS vs. a $5.4 million expense in 1Q21 or a 4-cent headwind. The credit arose due to reducing forecasts of how many awards would be exercised with the stock price down. Adjusted EPS adds back stock compensation so this did not impact the reported $1.76 EPS figure.

- Losing the Russian planes means about $18 million of quarterly lease revenue will vanish too. AL weighs that against the realized revenue from the deposits and noted that many of these planes only had 1-2 years of lease time left. It did not come up on the call, but we believe the rent was paid for at least January. Because AL recognized all the security deposits into income during 1Q, that won't repeat and the $18 million will be missing going forward. The company did note that six planes scheduled for delivery to Russia in early 2022 were placed with airlines in America and Europe, which offsets some of that.

That's the bad news that hit for 1Q22. There were some positives going forward too:

- The lost Russian planes are insured. There is no timing for it but eventually, it seems likely AL will get some settlements in this area that will flow to the bottom line. We would adjust it out of income as one-time, but it would boost book value again.

- AL guided to $750 million in aircraft sales for 2022 in the 10-Q. There were none in 1Q22 and they are expected to occur largely in 3Q and 4Q. We have been talking that with Covid and delays from Boeing and Airbus, this source of revenue and earnings has largely disappeared at AL for 2020 and started to return in 2021 but with only $138 million in sales. This should be lumpy, but could help bolster EPS. In 4Q21, this was $24 million in revenues and added as much as 21 cents to EPS.

- Covid deferred rent continues to decline at $190.4 million at the end of 1Q22 from $203.2 million at the end of 4Q22. That is accretive to revenue and is like earning 104% of scheduled rent – current due payments + delayed payments.

- AL has fixed-rate debt for 95% of its financing, but leases have interest rate escalators. Those are now working toward AL's benefit for higher earnings and revenues as rates increase.

- The delays from Airbus and Boeing may start to create an opportunity for AL. Many orders were canceled and airline customers took back their deposits. AL believes some of those orders are not fully completed due to a lack of parts. AL sees potential for those planes to be completed over 12-18 months and offered for sale by Airbus and Boeing. That could accelerate the rate of new planes coming in to AL.

Air Products & Chemicals (APD)

We are raising our earnings quality rating of APD to 4+ (Acceptable) and adding to our Top Buy list.

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

Summary

For the March 2022 quarter, APD's adjusted EPS of $2.38 beat forecasts by 1 cent. We give high marks that adjusted EPS and GAAP EPS were the same – no adjustments made. Plus, in recent quarters, APD has only reported adjustments for truly one-time items such as a gain on an asset transfer. It does appear that while energy costs remain high, they are no longer rising at the same rates, and APD's price increases have pulled ahead of cost increases last quarter.

- Pension income fell by $8.5 million y/y costing APD 3.1 cents in EPS
- Share compensation fell by $1.9 million y/y helping EPS by 0.7 cents
- Losses on hedging fell by $10.0 million y/y helping EPS by 4.5 cents
- The tax rate declined 180bp y/y helping EPS by 5.3 cents

Of these items, we would expect the tax rate to continue benefitting from APD increasing its investments in lower-tax areas overseas. We also believe there could be an adjustment to future earnings related to Russia and Ukraine. Russia is less than $25 million in sales and APD is divesting there and moved $54.1 million in assets to "other receivables" – we could see that being written off in the future. Also, Ukraine had a project under construction with $45 million spent so far. Ukraine is less than $5 million in sales, and if that project is not resumed – we could see the $45 million being written off too.

Raw Material Costs – Muddy Margin Analysis

Higher raw material costs make pass-through contracts appear to have lower margins. On-Site facilities are normally about half of APD revenues (51% in the 3/22 quarter and 49% for fiscal 2021 ended 9/21). These are facilities that supply gases to a specific customer on a long-term contract of 15-20 years. This is where the bulk of APD's pass-through contracts exist too. That simply means that APD is contracted to be paid a specific dollar figure per volume delivered. The raw materials and electricity appear in the revenue and cost of sales as the same figure. When the price of these items increases, the sales figure rises but the profit figure stays the same – it appears profitability is declining, which is not the case. Here is a simple illustration of what is happening:

	Base Period	Costs Rise	Next Quarter	Costs Rise	Next Quarter
Sales	$100	$20	$120	$35	$155
Cost of Sales	$80	$20	$100	$35	$135
Operating Profit	$20		$20		$20
Profit Margin	20.0%		16.7%		12.9%

The key is to focus on dollar figures for profit, not the margin. APD does a great job breaking out figures for pass-through items. For example, for the 1Q22 in December, APD noted that it had 26% y/y sales growth, with 14% coming from pass-through contracts and the higher costs seen in the market. That accounted for a 450bp decline in adjusted EBITDA margin. For 2Q22 in March, 18% y/y sales growth had 6% coming from pass-through contracts.

At the same time, the Merchant business where APD sells and delivers product to other customers does not have pass-through arrangements. APD generally raises prices during times of inflation to recover higher costs, but there can be a lagging impact. It appears that APD has managed to pull ahead of some of the inflation in the most recent quarter:

- From 3/22 earnings call: *"Volume was favorable at $0.18 and price net of variable cost was $0.14 as our price actions more than offset the unprecedented energy cost increases. For the quarter, our price actions alone before netting against variable cost contributed around $0.50."*

- From the 12/21 earnings call: "*Price for the quarter was again strong, the 4% gain for the region was equivalent to 10% on the merchant business, Price was better across all major products. This is the 13th consecutive quarter of year-on-year price improvement. Energy cost pass-through drove a 15% sales increase, with the much higher natural gas prices. EBITDA was 16% ahead of last year, as positive volume, price, better equity affiliate income and lower maintenance costs more than offset higher inflation. EBITDA margin was 230 basis points lower. However, energy costs pass-through negatively impacted EBITDA margin by approximately 500 basis points."*

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
EBITDA Margin	34.6%	33.5%	36.6%	37.5%	37.3%	39.2%
EBITDA $	$1,019	$1,003	$1,041	$976	$934	$932

Margins were above 40% in the past before inflation came through the income statement and APD is still targeting returning to that level. But the key point here is inflation raises revenue and costs and makes it appear the company is less profitable. Yet, actual dollar figures are rising. Getting past the lag impact of cost inflation preceding price hikes in the merchant business is also helping.

APD Appears Well-Positioned to Complete Its Build-Out

APD grows in a stair-step fashion. Projects take a long-time to build and do not generate revenues and cash flow until turned on. Thus the balance sheet reflects growing debt each quarter to fund additional growth capital spending. It spent $9.8 billion since 2018 in this area and expects to spend another $15.3 billion through 2027 as this program has grown since 2018.

APD is seeing growing EBITDA and free cash flow after maintenance spending and dividends is about $1.5 billion per year:

	2Q22	2Q21	2Q20	2Q19
TTM EBITDA	$4,039	$3,605	$3,649	$3,261
Interest/taxes	$459	$451	$464	$455
Maint. CapEx	$761	$655	$491	$389
Distributable Cash Flow	$2,819	$2,579	$2,694	$2,417
Dividends	$1,329	$1,185	$1,023	$966
Cash For Growth	$1,490	$1,394	$1,671	$1,451
Spent on Growth since '18	$9,800	$6,300	$3,900	$2,400
Future Spending	$15,300	$10,500	$7,800	$6,800

Looking at these figures there are some gives and takes:

- Positive- The EBITDA is growing and was impaired of late with cost increases exceeding price hikes to recover rising energy costs.

- Positive- New projects will keep turning on. Jazon I started in 2021 and has not annualized yet. Jiutai and Jazon II are expected in 1H23 (less than one year as fiscal 2023 starts Oct 1, 2022). Deborg and GCA are expected in 2H23. As these turn on, EBITDA should rise.

- Positive- Of the $15.3 billion to spend by the end of 2027, $1.5 billion per year in cash flow after the dividend and existing debt capacity of $7.9 billion (which assumes 3x trailing EBITDA for debt) covers nearly all of this. As EBITDA grows with new projects, more financing could likely be obtained there.

- Negative- Inflation can lead to some higher working capital investment that would be a drain on the free cash flow after the dividend. In the first 6 months of fiscal 2022, working capital was a $262 million cash drain vs. $91 million the year before.

- Negative- Does the dividend continue growing at 8% annually? Would APD need a year or two of more modest growth to preserve the cash flow to pay for growth?

Fulfillment Costs and Equipment Sales are Moving Together

We have talked about this in prior notes. APD sells and installs equipment at customer locations. It records payments received as Contract Liabilities which is the same as Deferred Revenues. Equipment installed is booked into an asset account called Current Contract Fulfillment Costs. It estimates the costs to complete the installation. It then recognizes the percentage of costs that have been incurred from total project cost and records the same percentage of revenue and costs. That pulls down the deferred revenue liability and the Current Contract Fulfillment Cost asset account.

There have been concerns with this because it would be possible to tweak revenue recognition or capitalize more costs and perhaps create more income in a given quarter. While these projects often take several quarters to complete, we have not seen much to concern us watching this over several years. A rising level for the asset called Contract Costs – tends to lead to higher revenues in the next quarter and vice versa. These balance sheet accounts appear to be turning quickly enough without problems. Also, we are seeing all the accounts move in the same direction with revenue tending to lag what the balance sheet accounts are doing by one quarter.

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Sales of Equipmt (I/S)	$239.8	$221.8	$297.9	$166.3	$163.8	$161.7
Contract Fulfillm Cost (B/S)	$226.6	$150.3	$125.5	$177.4	$154.5	$140.9
Contract Liabs (Def Rev) (B/S)	$636.6	$578.6	$425.2	$507.7	$472.4	$492.8

The first line is revenue being booked and is an income statement item. The other two are on the balance sheet. When the asset and liability grow, revenue jumps the next quarter, and when the balance sheet shrinks (projects are completed) revenue declines the next quarter. 3Q21-1Q22 shows this well.

We see little reason for concern in this area. It also appears that business has grown stronger for APD with that the balance sheet items at the highest level we've seen in years which could mean higher revenues in this area.

Hedging Gains/Losses Are Volatile

As noted in the introduction, a drop in the losses on hedges added $10 million to income or 4.5 cents for the March 2022 quarter. APD is buying and selling huge quantities of commodity items and it hedges much of its exposure there. It is producing and selling product in many overseas markets giving it a large FX exposure risk and it hedges that risk too. Finally, APD is working on several growth projects and building them. Much of that requires issuing debt and APD also hedges its interest rate exposure.

APD markets its positions to market on a regular basis and much of the gains and losses are cumulatively recorded in AOCL (Accumulated Other Comprehensive Loss) and impact the equity balance but not income. That is for positions that are designated as a hedge. When a position is not a hedge or no longer meets the criteria to be a hedge and involves a derivative – the gain or loss is recorded as income and normally appears in “Other non-operating income, expense” line. Often there is a small amount of loss or income in a given quarter:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Hedging loss (gain)	$26.0	$18.7	$20.0	-$13.1	$36.0	-$1.3

While this bounces around a bit, we are going to consider has there been a more weird time than in the last several quarters? FX markets went crazy from 2019 to 2020 to 2021. Commodity costs crashed in early 2020 and then rose considerably in 2021 and now even interest rates are rising.

In any given quarter the y/y change for APD may be 1-4 cents in this area. We think this is very minor for a company that is expected to earn north of $10 per share.

Joint Ventures Pose Some Additional Risks

Many of the new JVs under construction are in Saudi Arabia and China, which brings some FX issues. As APD found during Covid in 2020 when its Lu’An facility in China was closed during lockdowns – it may not have some risk of that recurring. That could also mean projects are not completed on time even though APD may still need to keep investing new money to complete the new plants.

In cases where the JVs are not consolidated, they are treated as equity investments. The share of the earnings recognized is not cash. Only dividends paid to the various partners represent cash in the door. To us that poses a risk in that it can lead to overstatements for EBITDA. Also, APD wants to leverage new plants after start-up to help pay for the remaining projects under construction. As a JV, it may not have that ability, or the dividend being paid to APD may not justify as much additional debt as an EBITDA figure could.

Altria (MO)

Update on 3/22 results and 10-Q review

We are maintaining our earnings quality coverage of MO at 2- (Weak) and maintain Top Sell rating.

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

Summary

Altria's adjusted EPS of $1.12 in 1Q22 beat forecasts by 3 cents. The company did not raise guidance and expects the modest EPS growth forecast of 4%-7% to be backloaded in the year. We noted that:

- Share repurchases added 2.3 cents to results. MO used the proceeds of $1.2 billion in proceeds from selling its wine business to repurchase shares. MO spent just under $1.3 billion on share repurchases in 4Q21 and 1Q22.

- Selling the wine business helped improve gross margin, and SG&A costs declined as well. However, in 1Q21, MO was ramping up marketing programs for IQOS (heated tobacco), which it has since been prohibited from doing. It was rolling out a new device, was offering Marlboro reward points to use for discounts buying an IQOS device (that sounds like trade marketing that would likely be recorded against sales), and it was educating retailers and customers on the product. We can't quantify how much spending was done in that area in 1Q21, and the fact that MO still had the wine business at that time, clouds this issue further. On the 1Q21 call – this marketing for IQOS was being rolled out in a big way with plans for that to grow further in 2Q21. So, we would speculate that this may have been the entire 3-cent beat y/y if MO spent over $70 million on this roll-out last year. 1Q21's smoking income only rose 0.1% y/y when the marketing started.

- Adjusted earnings add back a number of items – so these would NOT have an impact on y/y adjusted EPS or the 3-cent beat. But many are recurring items:

    - MO saw litigation costs fall from $35 million to $12 million y/y – adding 1 cent

    - MO saw another impairment for JUUL due to higher discount rates – adding back 5 cents to adjusted EPS

The Bigger Picture

Altria is one of those stocks whose popularity continually stuns us because people absolutely love the dividend despite even the company admitting that it is unlikely to sell its top product forever. This quote is prominently displayed on MO's website and referred to throughout its earning calls and presentations:

> " ***Our Vision*** is to responsibly lead the transition of adult smokers to a smoke-free future."

We think this is a company that is followed too closely on a quarter-to-quarter basis and many investors do not realize how much cigarette demand has vanished. The market was doing a solid job eliminating smoking before this became MO's motto.

- In 2001, MO sold 207.1 billion cigarettes and was 51.0% of the US market

- In 2021, MO sold 93.8 billion cigarettes (55% less volume) and was 48.8% of the US market

- Covid gave MO a reprieve in 2020 as the decline almost disappeared for one year 101.4 billion cigarettes vs. 101.8 billion in 2019, but the decay rate was accelerating before and after:

Altria Cigarette Vol. Growth	4Q	3Q	2Q	1Q
2022				-8.0%
2021	-8.0%	-7.0%	-4.5%	-3.5%
2020	-1.0%	-1.0%	-2.0%	-3.5%
2019	-6.0%	-7.0%	-7.0%	-7.0%

- Smoking is 86%-88% of total company income and is helped by MO continually raising prices, but the rate of growth in this area has slowed considerably from a consistent 7%-10% in recent years to only 4% in 2021, which included a negative growth quarter in 3Q21 and a mere 0.1% growth in 1Q21.

- Smoking is getting hit from multiple angles of late and the squeeze may keep coming

    - Teens can't buy – The decay rate is a net figure of the people who quit + new people who start smoking. The research shows nearly all people who smoke started before age 21 and only 1% start after age 25. The new law nationwide requires people to be over 21 to purchase cigarettes. We think that is accelerating the net decay rate in volume.

- Graphic packaging showing negative health impacts of smoking begins in April 2023 – This has proven to cut smoking rates and reduce new smokers in every country where it has rolled out.

- Potential menthol bans – menthol cigarettes are estimated at about one-third of the smoking market. Some states have already moved to ban it and the FDA has been working toward a national ban for several years too. That is now moving forward in recent weeks and could become law in a couple of years.

- The FDA has also been studying lowering nicotine levels in cigarettes and has concluded it could quickly lower smoking levels. It is still researching this further.

- Inflation – MO is very clear that high gasoline and food prices drain consumer wallets and lower cigarette purchases.

What is MO's plan to replace smoking? So far we've seen little tangible results

- JUUL has been a bust so far. Shortly after MO acquired its stake in JUUL and JUUL distributed MO's cash to employees and other investors, JUUL's outlook changed. The 21-year age limit was applied to e-cigarettes and vapor and many of the flavorings were banned. Plus, lawsuits began. MO spent $12.8 billion here and has written off $11.2 billion of the investment. Its carrying value is $1.6 billion after 1Q22. JUUL also cannibalized cigarettes. So MO was trading 100% cash income from cigarettes for a 35% share of equity income from vapor.

- The Cronos pot company in Canada was a $1.9 billion investment. This company has posted negative gross profit in some quarters. The carrying value for this is now $556 million.

- IQOS heated tobacco is on hold after courts determined MO and PM violated patent rights. The rollout in late 2020 and into 2021 was halted and MO cannot sell the product now. At some point, this may reemerge as a redesigned product. History has shown heated tobacco collapses cigarette smoking in markets quickly. It is more expensive for the company given marketing, research, and production spending are higher than with cigarettes. The goal here is also to help people quit nicotine altogether, not to become a permanent heated tobacco user. First-mover status could help as MO may have captured smokers from competitors, but it may not have that status now with the patent issues delaying the product.

Ball (BALL)

Update on 3/22 results and 10-Q review

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

Summary

BALL's non-GAAP EPS for the 3/22 quarter fell 6 cps short of consensus targets while revenue topped estimates by more than 5%. Key areas of disappointment in the quarter included a 21% volume decline in revenues in South America which the company blamed on weak performance from Brazil stemming from a sharp fall in the purchasing power of the consumer.

North America saw volumes rise by only 3% which the company admitted was below its expectations. It blamed the shortfall on consumer products companies taking price in the first quarter which dampened their sales volumes as well as customers pre-buying in 4Q21 ahead of BALL's contracted price increases. Management still believes forecasts for the year for North America are doable.

There also seemed to be concern on the call regarding aluminum availability impacting both the demand for and ability to produce aluminum cans. This seems overdone to us given the secular shift away from plastic due to ESG pressures not to mention the fact that aluminum spot prices have been plummeting since the end of March. Also, oil is over $100 with many supply questions of its own which hardly makes plastic a more attractive alternative for CPG companies.

In the area of earnings quality we note the following items:

- While the company raised the limit of its receivables factoring facility, its factored but outstanding receivables balance continued to fall for the third straight quarter. However, total receivables adjusted for factored but outstanding balances were up with lower factoring and swings in aluminum prices likely playing roles. This helped drive overall outstanding receivables DSOs higher which was a drain on cash flow.

- All inventory components rose in the quarter as the company successfully rebuilt its inventory levels. We had previously warned that the company's use of average cost inventory accounting for some of its inventories could result in higher costs in the quarter in an environment of skyrocketing aluminum prices as the cost of sales would reflect the higher costs regardless of whether the inventory was sold. We wonder if this could have contributed to some of the profit disappointment in the quarter. However, aluminum prices have fallen precipitously since the end of the quarter which could put the company in more of a bind in negotiating pass-through provisions for the rest of the year.

- The reserve for obsolete and slow-moving inventory has fallen sharply as a percentage of gross inventory for the last two quarters. We estimate it would take a charge of about 7 cps to restore the reserve to a historically normal level.

While we are maintaining our 3- (Minor Concern) earnings quality rating on BALL, we note that the decline in the stock price appears excessive to us. BALL's massive capital spending program gives the company a "pipeline" quality in our minds. The company opened 12 billion units of additional capacity in 2021 and anticipates a like increase in 2022. All of this new capacity is reportedly already spoken for and the secular shift to aluminum from plastic containers seems to be intact. Our concern with BALL all along has been the degree to which it is relying on receivables factoring and increasing payables to fund this expansion and the resulting risk of short-term hiccups. However, unlike most of the low-quality names being sold off in the market today, BALL is a real company that will generate substantial free cash when the $1 billion of excess capex begins to roll off.

Receivables Factoring Declined Accelerating the Drain on Cash Flow

BALL is undergoing a massive capital spending program to build out its production capacity and one of the ways it was financing this program was through the aggressive expansion of its receivables factoring program. The company sells receivables off its balance sheet to third-party financing companies who then receive customer payments as they come in. This acts as a form of short-term financing as the company gets its cash now instead of having to wait 4-6 weeks as it would for the receivables left on the balance sheet. However, we have pointed out in the last couple of quarters that the company is factoring fewer receivables which is resulting in a drain on cash flow growth. The following table shows a breakdown of receivables between those left on the balance sheet and what has been factored but is still outstanding. Note that we estimate the amount factored by taking the difference between the limit of the factoring facility and what is still available under the facility.

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Sales	$3,716	$3,674	$3,553	$3,459
Net Trade + Unbilled	$2,495	$2,022	$1,976	$2,102
DSO	**60.4**	**50.6**	**51.2**	**55.3**
Outstanding Factored Receivables	$1,108	$1,392	$1,270	$1,473
Factored DSO	**26.8**	**34.9**	**32.9**	**38.8**
Adjusted Receivables	$3,603	$3,414	$3,246	$3,575
Adjusted DSO	87.3	85.5	84.1	94.1

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Sales	$3,125	$3,102	$3,093	$2,801
Net Trade + Unbilled	$1,640	$1,344	$1,418	$1,447
DSO	**47.2**	**39.9**	**42.2**	**47.0**
Outstanding Factored Receivables	$1,252	$1,368	$1,316	$1,073
Factored DSO	**36.1**	**40.6**	**39.1**	**34.9**
Adjusted Receivables	$2,892	$2,712	$2,734	$2,520
Adjusted DSO	83.3	80.4	81.3	81.9

Despite the company expanding the limit of the facility from $1.7 billion in the 12/21 quarter to $2 billion at the end of the 3/22 quarter, the amount of receivables factored but outstanding fell noticeably both sequentially and year-over-year. The decline in factoring mutes cash flow growth as less cash is received upfront. These receivables that are not factored wind up staying on the balance sheet where they are collected more slowly. This is resulting in a steady rise in adjusted DSO based on receivables still on the balance sheet plus receivables that are factored but outstanding. This not only is suppressing cash flow growth but also the rate of generation of new receivables relative to sales does call into question if the company may be offering more generous credit terms to customers.

Raw Materials Are Back Up

We expressed concern last quarter about the fact that BALL's raw materials inventory in the 12/21 quarter was flat sequentially with the 9/21 quarter despite a significant increase in aluminum prices. The company utilizes both FIFO and Average Cost accounting for its inventories. Under average cost accounting, the cost of sales is immediately impacted when higher-cost inventory is acquired regardless of whether the inventory is sold that quarter or not. We were concerned that BALL's gross margins could have benefitted in the 12/21 quarter by the delay in acquiring higher-cost raw materials. The company was able to rebuild its inventory in the 3/22 quarter as raw materials, work in process, and finished goods inventories all rose sequentially and year-over-year in the 3/22 quarter as seen in the table below:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Raw Materials & Supplies DSI	35.8	32.8	32.7	31.2
Work in process and finished goods DSI	36.2	25.3	23.1	21.1
Inventory Reserve DSI	-2.7	-2.8	-2.9	-3.1
DSI	69.3	55.4	52.9	49.1

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Raw Materials & Supplies DSI	31.3	33.4	32.3	36.0
Work in process and finished goods DSI	22.5	20.9	20.9	24.6
Inventory Reserve DSI	-3.4	-3.5	-3.6	-4.0
DSI	50.5	50.8	49.6	56.6

Aluminum prices soared during the first quarter and we wonder if some of the profit disappointment stemmed from acquiring raw materials at this higher cost which drove up the average cost. However, aluminum prices fell off sharply at the end of the quarter which may put the company in a difficult position in negotiating higher pass-throughs under its contracts if prices remain suppressed for the rest of the year.

Note that while aluminum is the key raw material, energy is also a key component of the company's cost structure and that is becoming a significant source of pressure, particularly in its European operations. Consider the following commentary from management on the conference call regarding its pass-through negotiations with customers:

> *"One of the things is we did not experience a lot of inflation in Q1. It accelerated towards the tail end of the quarter. So it's a little bit more of what's yet to come versus what we've experienced. I will say how that plays into the cost recovery discussions that we initiated kind of November-December time frame with our customers is those conversations have been going well.* ***But we haven't secured 100% short-term pricing pass-through****. As you can imagine, these conversations are ongoing. We're trying to make those as equitable as we can moving forward in the event that we're moving into a more of a high inflation environment. So there's more work to do.* ***And I think it would be safe to say that I don't think we anticipated the level of inflation that we're now seeing in Europe.*** *There's more work to do, but our contracts are sound. We will get this back. Europe may look a little bit more like North America did last year and then transitioning into this year relative to the pass-through."*

Inventory Reserve Declining

One item of concern to keep an eye on is the company's declining reserve for obsolete and slow-moving inventory. Inventory reserves are typically created with a charge to cost of sales at the time the inventory is acquired. If the company has underestimated the amount of inventory that will go bad, it may result in a charge to earnings when this becomes obvious and the inventory is written off. If the inventory is later found to be viable, the company will reduce the reserve with a debit while crediting the value of the inventory.

The following table shows the reserve as a percentage of gross inventory for the last sixteen quarters:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Inventory Reserve	$91	$90	$90	$94
Gross Inventory	$2,414	$1,885	$1,728	$1,584
Reserve %	3.8%	4.8%	5.2%	5.9%

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Inventory Reserve	$93	$93	$94	$97
Gross Inventory	$1,492	$1,446	$1,403	$1,485
Reserve %	6.2%	6.4%	6.7%	6.5%

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Inventory Reserve	$86	$82	$81	$79
Gross Inventory	$1,440	$1,356	$1,261	$1,262
Reserve %	6.0%	6.0%	6.4%	6.3%

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Inventory Reserve	$71	$70	$68	$57
Gross Inventory	$1,346	$1,341	$1,311	$1,314
Reserve %	5.3%	5.2%	5.2%	4.3%

Looking back over the last four years, we see that the inventory reserve as a percentage of gross inventory has run in the 5-6% range fairly consistently. However, the reserve percentage has gone sharply down in the last two quarters. As we noted above, this could be either a sign that the company has reduced its rate of reserving for new inventory purchases, or it has suddenly been seeing less inventory go bad. The first case would provide an artificial but temporary benefit to earnings. The second one wouldn't. Given the fact that the decline has spanned two quarters and appears to have accelerated makes it look to us like the company changed its rate of reserving for new inventory which would have provided a tailwind to EPS. To get an idea of the potential benefit to earnings, we estimate that to get the reserve percentage back to 5% would require a charge of about 7 cps.

Weakness in Latin America

Latin America was a key weak spot in the quarter with management placing most of the blame on Brazil which experienced significant volume declines. Management gave good color on the topic in the conference call:

> *"Yes. Thanks for that. One thing that you did indicate, just to be clear on this, volume -- liquid volume was down 15%. And so plus or minus that number is kind of where we ended up in terms of volume decline, and a lot of that has to do with discretionary spending power in Brazil because all of the other countries surrounding in South America performed really much better than Brazil, Southeast Brazil, in particular. So I think rough math, what our colleagues in South America and Brazil specifically were telling us is your spending power was cut by 1/3 basically over the last three to four months. And on top of that, because these products are U.S.-denominated in terms of the aluminum profile of them, our customers were passing through price on top of that, so you could see a 30% to 40% impact on an end consumers' buying power relative to a package in Brazil. The things that are going to be transitory relative to allowing recovery in the second half of the year and why we're a bit bullish on the back half of the year, in particular, a couple of things. Number one, it's an election year. It's an election year in Brazil. So what that means is there's a stimulus package coming. That will certainly help. You referenced in your question timing in and around Carnival. As we sit here today, we believe that there will be a carnival reflective of what you've seen in years past, a street carnival. Somewhere in July is what's being contemplated. And the last thing is there's a World Cup, and the World Cup sits in a different time slot than typically does. So a November World Cup, we should see the benefits of that. And that's what our customers are certainly building and discussing with us. So I think you'll see a second half performance lift kind of versus where we anticipated. I don't know if that's all going to be able to make up for what we experienced in the first quarter. But I think there are plenty of things to point to that we'll see continued strong performance, not only in the extending surrounding South American countries, but in Brazil, in particular, where the decline was in the quarter."*

This will be a key area to watch during the rest of the year.

Ecolab (ECL)

Update after 3/22 Quarter Results and 10-Q Review

We maintain our earnings quality rating of ECL at 3- (Minor Concern) but move from Top Sell given the improvement in the inventory situation.

Summary

ECL reported non-GAAP EPS of $0.82 in the 3/22 quarter which missed consensus estimates by a penny while revenue came in above targets. The company forecast for 2Q22 earnings to approximate last year's figure of $1.22, but is calling for accelerating earnings growth in the back half with "low teens" earnings growth for the full year, consistent with its outlook at the end of the year.

Management cautioned that much would depend on the timing of the energy surcharge it plans to implement. These charges are intended to offset the higher cost of energy resulting from the Russian invasion of Ukraine, will range from 8-12%, and will be levied on the whole customer base. The company raised prices by 3% in 4Q21, 5% in 1Q22, and expects pricing to increase 6-7% for the balance of the year. Management indicated it is pleased with how pricing is being received by customers but the timing and success of the surcharges and price increases will be key to the company meeting expectations over the next couple of quarters.

We continue to see a risk for higher than expected costs to lead to disappointment in upcoming quarters.

- Raw materials inventory balances rose by almost 30% year-over-year. However, the company stated that cost inflation was running at 25% in the quarter. While the situation has improved somewhat from the end of the 12/21 quarter, there still was not much rebuilding on a unit basis. Inflation is expected to jump to 30% in 2Q22 which will put the company replenishing inventory at elevated levels. With almost 30% of inventory accounting for under LIFO, these higher-cost units will hit the income statement as soon as sold which increases the risk of disappointment if the company is delayed implementing its planned energy surcharges or gets pushback from its price increases.

- The company took almost $18 million in charges to write down the value of excess Covid sanitizer products which it added back to non-GAAP earnings. These charges continue to roll in and it is not known if the company is selling some of this inventory which would result in an artificial boost to margins from the reduced cost basis.

- Also added back to non-GAAP results was $27 million in amortization of the inventory step-up related to the acquired Purolite inventory. Many companies add these amounts back to non-GAAP earnings but we have always believed that it distorts the economic picture in terms of inflation, especially for a company that normally utilizes LIFO accounting for approximately 30% of its inventories.

Inventory Unit Growth Appears to Still Be Lagging

We noted our concern in our last review that the company's inventory was lagging unit sales growth. Our concern was that profits could have been helped temporarily if the company ate into lower-cost LIFO layers in the 27% of inventories that were accounting for under LIFO. The declining raw materials balances also put the company in a position of replenishing inventories at much higher prices. The below table shows the components of inventory for the last eight quarters:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Finished Goods	$1,039.5	$1,010.6	$886.5	$879.9
Raw Materials and Parts	$687.5	$596.1	$550.2	$578.6
FIFO cost to LIFO Cost Difference	-$137.1	-$114.9	-$58.5	-$40.0
Total Inventory	$1,589.9	$1,491.8	$1,378.2	$1,418.5

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Finished Goods	$845.8	$789.6	$781.6	$750.0
Raw Materials and Parts	$530.0	$511.2	$531.3	$503.9
FIFO cost to LIFO Cost Difference	-$28.8	-$15.6	-$25.1	-$25.2
Total Inventory	$1,347.0	$1,285.2	$1,287.8	$1,228.7

And here are the inventory components on a DSI basis:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Finished Goods DSI	45.1	45.5	40.4	43.4
Raw Materials and Parts DSI	29.8	26.8	25.1	28.6
FIFO cost to LIFO Cost Difference DSI	-6.0	-5.2	-2.7	-2.0
DSI	69.0	67.2	62.9	70.0

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Finished Goods DSI	44.5	40.8	40.6	41.7
Raw Materials and Parts DSI	27.9	26.4	27.6	28.0
FIFO cost to LIFO Cost Difference DSI	-1.5	-0.8	-1.3	-1.4
DSI	70.8	66.4	67.0	68.4

We see that raw materials did increase both sequentially and year-over-year in the 3/22 quarter. Also, raw materials DSIs increased by almost 2 days which puts the company in a better position than it was at the end of the year. However, we still note that the 30% YOY increase in raw materials inventory was not significantly higher than the 25% YOY increase in costs the company cited in the quarter implying that the inventory build may not have been as high on a unit basis as the figure above indicate. As noted above, management expects YOY inflation to hit 30% in Q2, meaning the company will be buying new inventories at very high levels. Also, with over a quarter of inventories accounted for under LIFO, much of the impact of these higher costs will be felt immediately. We see this adding a degree of risk of more disappointment on the cost side in 2Q22 if the company is delayed in pushing through the surcharges or gets more pushback than expected from its price increases.

More Covid Charges

ECL took another $17.8 million in Covid charges in the quarter which it added back to non-GAAP results. The bulk of these charges related to writedowns of Covid sanitation product inventories. It is not known if these products will be sold in the future but if so, it could result in an artificial boost to profits due to a lower cost basis.

Inventory Step-Up Charge

Also added back to non-GAAP results was $27.4 million in integration charges which the company attributed to the recognition of the fair value step-up in the Purolite inventory acquired in the previous quarter. At the time of the Purolite acquisition, ECL would have marked up the value of Purolite’s inventory to reflect the cost of the inventory at the time the deal closed. The higher value was largely the result of cost inflation. Accounting rules require ECL to amortize this increase in value over the estimated time that the inventory is sold. The inventory step-up ECL added back was the amortization charge associated with the increase in the value of the inventory. While this is very common to see inventory step-ups added back, we believe this distorts the economic picture. It essentially has the effect of converting the accounting for that inventory from LIFO (current cost) to FIFO (historical cost.) However, ECL uses LIFO for almost 30% of its inventories on a regular basis. Also, in times of inflation, this benefit increases in size.

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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