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:

Ecolab Inc. (ECL)
Earnings Quality Update

We are maintaining our EQ rating of ECL at 3- (Minor Concern).

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

Summary

ECL posted non-GAAP EPS of $1.10 in the 6/22 quarter which was a penny ahead of the consensus estimate while sales were almost $100 million ahead of expectations. However, we saw several minor one-time benefits to the quarter which make this a low-quality beat in our mind. We are also puzzled by the sequential decline in the LIFO reserve.

- Inventory DSIs rose slightly in the quarter which we take as a positive as it indicates that unit inventories are not declining. However, we are puzzled by the $13 million sequential decline in the LIFO reserve. The company accounts for about 25% of its inventories under LIFO. The LIFO reserve represents the excess in the cost of the latest units purchased versus the older units in inventory. We find it unusual for the reserve to decline sequentially while total inventory balances increased in a period of rising prices. This makes us wonder if the inventory rebuilding has disproportionately occurred in the FIFO and Average Cost portions of inventory which could be temporarily benefitting costs. The $13 million decline in the LIFO reserve represents about 3.5 cps in expense.

- Other income was up by 0.7 cps even after adjustment for the $19.6 million one-time pension settlement charge in last year's June quarter which was taken out of non-GAAP profits.

- ECL added back a penny per share in COVID-related charges. This is down from 5 cps in the 3/22 quarter, 11 cps in the 12/21 quarter, and 14 cps in the 9/21 quarter. In the past, these charges have included write-downs for excess sanitizer inventory. However, according to detail in the 10-Q, the June charges include $500,000 to "protect the wages of certain employees" and $2.7 million for testing and related expenses. While we are encouraged by the reduction in the charges, we would argue that testing may very well become a regular expense for companies in the new environment and we question adding it back as one time. We also remain concerned by the inventory writedowns in previous quarters. For example, ECL increased its sanitizer inventory reserve by $15 million in the 3/22 quarter and it is unclear if this product could have been sold in this quarter at a reduced cost basis.

- Restructuring charges fell to $1.1 million which is a positive. Management specifically noted on the call that it is not planning a major restructuring so any meaningful return of the charges should be viewed with skepticism.

Why Is the LIFO Reserve Down?

We pointed out in our review of the 12/21 quarter that inventory days declined after adjusting for the impact of an acquisition. Our concern was that the decline in inventories on a unit basis could have artificially helped margins by both expensing older, lower-cost LIFO inventory layers and by delaying the impact of adding higher-cost units to its Average Cost inventory calculation.

We were encouraged by the increase in inventory DSIs in the 3/22 quarter. At first glance, DSIs showed slight improvement again in the 6/22 quarter. The following tables show inventory components on an absolute and DSI basis for the last twelve quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Finished Goods	$1,101.8	$1,039.5	$1,010.6	$886.5
Raw Materials and Parts	$743.0	$687.5	$596.1	$550.2
FIFO cost to LIFO Cost Difference	-$124.1	-$137.1	-$114.9	-$58.5
Total Inventory	$1,720.7	$1,589.9	$1,491.8	$1,378.2

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Finished Goods	$879.9	$845.8	$789.6	$781.6
Raw Materials and Parts	$578.6	$530.0	$511.2	$531.3
FIFO cost to LIFO Cost Difference	-$40.0	-$28.8	-$15.6	-$25.1
Total Inventory	$1,418.5	$1,347.0	$1,285.2	$1,287.8

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Finished Goods	$750.0	$976.3	$668.5	$1,003.6
Raw Materials and Parts	$503.9	$543.2	$437.9	$580.9
FIFO cost to LIFO Cost Difference	-$25.2	$10.2	-$24.8	$2.2
Total Inventory	$1,228.7	$1,529.7	$1,081.6	$1,586.7

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Finished Goods DSI	45.3	45.1	45.5	40.4
Raw Materials and Parts DSI	30.6	29.8	26.8	25.1
FIFO cost to LIFO Cost Difference DSI	-5.1	-6.0	-5.2	-2.7
DSI	70.8	69.0	67.2	62.9

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Finished Goods DSI	43.4	44.5	40.8	40.6
Raw Materials and Parts DSI	28.6	27.9	26.4	27.6
FIFO cost to LIFO Cost Difference DSI	-2.0	-1.5	-0.8	-1.3
DSI	70.0	70.8	66.4	67.0

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Finished Goods DSI	41.7	51.6	34.0	51.8
Raw Materials and Parts DSI	28.0	28.7	22.3	30.0
FIFO cost to LIFO Cost Difference DSI	-1.4	0.5	-1.3	0.1
DSI	68.4	80.9	55.0	82.0

We see that DSI improved slightly sequentially and YOY in the 6/22 quarter. This does not indicate a huge buildup in units, but it does indicate inventories are being slowly replenished.

However, we find it interesting that the LIFO reserve fell to $124.1 million in the 6/22 quarter from $137.1 million in the 3/22 quarter. According to the 2021 10-K, as of 12/31/21, ECL used LIFO for 27% of inventories with the balance calculated under either Average Cost of FIFO. Companies typically internally account for all inventories under the FIFO method. The LIFO reserve represents the adjustment it makes to convert the 27% of its inventories internally accounted for under FIFO to a LIFO cost basis at the time they are expensed. In times of rising prices, the LIFO reserve will be a reduction to inventory balances since under LIFO, these units would have a higher cost than they would under FIFO. The $137.1 million LIFO reserve in the 3/22 quarter essentially means that LIFO units expensed that quarter cost $137.1 million more at today's costs than they did if they were accounted for under their FIFO cost basis.

So, our question is how in a time of rising prices and positive unit volume growth did the LIFO units expensed in the 6/22 quarter cost $13 million ($137.1-$124.1) less than the LIFO units expensed in the 3/22 quarter? We wonder if this is an indication that the company did eat into LIFO layers in previous quarters and while it is rebuilding inventory units, the rebuilding is taking place at a disproportionate pace in its FIFO inventories. If so, this could be helping reduce the impact of rising costs. To put this in perspective, the $13 million reduction in the LIFO reserve represents about 3.5 cps in expense. We are not saying this is an intentional manipulation. Nevertheless, the numbers look unusual. This will be an interesting area to watch for the remainder of the year. It will also be interesting to see the LIFO disclosure in the 2022 10-K to see what percentage of inventories are still accounted for under LIFO.

Post Holdings, Inc. (POST)
Earnings Quality Update

We are cutting our earnings quality rating of POST from 3- (Minor Concern) to 2- (Weak).

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

Summary

POST beat fiscal 3Q22 (June) EPS estimates of 55 cents by 14 cents. We saw that they cut advertising by $6.5 million to pick up 8 cents and for a company that continually makes acquisitions, it added back a catch-all of restructuring, integration, purchase price adjustments, and even something called “costs expected to be indemnified” of $6.2 million for another 7.6 cents.

POST picked up $128.1 million in sales via prior acquisitions too. Margins in those units range from 4%-22%. At a 4% margin, this added 6 cents to EPS for the quarter. At a 10% margin, this added 16 cents.

- Inventory levels are still looking like a problem as DSIs continue to decline.

Inv. DSIs	4Q	3Q	2Q	1Q
fiscal 2022		41.3	45.8	46.5
fiscal 2021	42.8	55.1	56.5	53.2
fiscal 2020	56.3	61.8	49.2	54.5
fiscal 2019	53.4	52.4	54.1	46.2

POST uses FIFO accounting, which should benefit gross margins the most during inflation. It still looks like POST is trying to avoid purchasing inventory during inflation and hoping costs improve before stocks run too low. Inventory in dollar terms is actually still rising and it is cutting into cash flow as it still makes acquisitions and the inflation impacts the inventory that is being replaced. POST said on its earnings call that it needs to build inventory before the holidays.

What happens if POST does need to replenish stocks at higher prices? Adding 10 days of inventory would cost $125-$130 million. For the holidays, they may need 15-20 days of inventory. Through nine months, POST's free cash flow is $27.5 million.

- "POST is raising prices too while expensing older, lower-cost FIFO inventories. This is protecting its margins relative to peers who utilize LIFO for some of their inventories. Despite this, gross margins are still plummeting. Replacing inventory at higher prices may make this worse.

Segment	**3Q**	**2Q**	**1Q**
Post Consumer Price	9%	6%	8%
Post Consumer Vol	7%	3%	-9%
Post Consumer margin	-500bp	-500bp	-200bp
Weetabix Price	7%	8%	6%
Weetabix Vol	-6%	-2%	-4%
Weetabix margin	-100bp	flat	-200bp
Food Serv. Price	27%	10%	8%
Food Serv. Vol	6%	11%	12%
Food Serv. Margin	200bp	200bp	flat
Refrig Retail Price	9%	5%	5%
Refrig Retail Vol	4%	2%	-7%
Refrig Retail margin	-200bp	-400bp	-800bp

- Debt is $6 billion. On EBITDA guidance that is 6.4-6.5x EBITDA. The company said on the earnings call, *"We continue to aggressively pursue M&A and in the last 2 years, have completed 6 tuck-in acquisitions. We expect the volatile markets to lead to some larger opportunities."* It also has until May 2023 to close on a deal for its SPAC too – it claims to be looking still. This all sounds like more debt is possible for POST.

Sysco Corporation (SYY)
Earnings Quality Update

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

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

Summary

SYY reported non-GAAP EPS of $1.15 in its fourth fiscal quarter ended 6/22 which was 4 cps ahead of consensus estimates. Sales beat the top line target by over $600 million. However, the stock fell on guidance for fiscal 2023 that was weaker than the market was expecting.

While the 10-K is not out yet, we wanted to comment on negative earnings quality trends we saw worsen in the quarter.

- We noted in our review of the previous quarter that the unusual benefit the company was receiving from its artificially low adjusted provision expense has turned into a headwind. However, this unsustainable benefit returned with a vengeance in the latest quarter, adding 2.5 cps to earnings growth. (See details below)

- Restructuring and Transformational Project Costs added back to non-GAAP earnings remained high at 7.7 cps. The size and seemingly arbitrary nature of the add-backs reduce the quality of adjusted earnings. (See detail below)

- The company added back 8.5 cps in additional Covid inventory write-downs, up from the 5.8 cps added back in the last quarter. We are seeing more people wearing masks with the uptick in the new variant. Is the company selling these inventories now with a reduced cost basis?

Lower Adjusted Provision Expense Added 2.5 CPS

We have explained in past reviews how the company ramped up its provision for bad debts when the pandemic hit in 2022. It added back the incremental increase in provision expense related to receivables created before the pandemic to its non-GAAP earnings in the 3/20 and 6/20 quarters. We did not have serious concerns at the time. However, in the 9/20 quarter, the company began collecting on some of its “pre-pandemic receivables” and reduced its allowances as a result. It began to take the gains from the reduction in reserves out of its non-GAAP results in the 9/20 quarter. This all seems reasonable and conservative. However, the problem is that receivables created ***during*** the pandemic also had higher than usual reserves established against them and also experienced better than expected collections but the impact of reversing those reserves was not being removed from non-GAAP results.

The following table shows the GAAP provision/(credit) for bad debts, the related non-GAAP adjustments, and the implied non-GAAP provision expense for the last twelve quarters:

	7/2/2022	4/2/2022	1/1/2022	10/2/2021
GAAP Provision (Credit) for Losses on Receivables	-$16.066	-$0.936	-$0.589	$2.097
Provision (Credit) for Bad Debt Expense Removed from Non-GAAP	-$8.783	-$5.717	-$6.438	-$7.061
Provision (Credit) for Bad Debt Expense Used in Non-GAAP Earnings	-$7.283	$4.781	$5.849	$9.158
Percentage of Revenue	-0.04%	0.03%	0.04%	0.06%
EPS Impact of Change in Provision %	$0.025	-$0.029	$0.021	$0.031

	7/3/2021	03/27/2021	12/26/2020	9/26/2020
GAAP Provision (Credit) for Losses on Receivables	-$15.070	-$43.428	-$16.452	-$77.790
Provision (Credit) for Bad Debt Expense Removed from Non-GAAP	-$22.441	-$33.473	-$30.271	-$98.629
Provision (Credit) for Bad Debt Expense Used in Non-GAAP Earnings	$7.371	-$9.955	$13.819	$20.839
Percentage of Revenue	0.05%	-0.08%	0.12%	0.18%
EPS Impact of Change in Provision %	$0.046	$0.044	$0.002	-$0.010

	6/27/2020	3/28/2020	12/28/2019	9/28/2019
GAAP Provision (Credit) for Losses on Receivables	$190.389	$175.351	$19.706	$18.712
Provision (Credit) for Bad Debt Expense Removed from Non-GAAP	$169.903	$153.499	$0.000	$0.000
Provision (Credit) for Bad Debt Expense Used in Non-GAAP Earnings	$20.486	$21.852	$19.706	$18.712
Percentage of Revenue	0.23%	0.16%	0.13%	0.12%

We discussed in our review of last quarter that the artificial tailwind of reversing reserves on “**pre-pandemic**” receivables had turned into a headwind. However, we see above that the company took a provision ***credit*** of $16 million in the most recent quarter, but only adjusted $8.8 million of the credit out, leaving a $7.3 million credit in the calculation of non-GAAP earnings. We estimate if the adjusted provision expense has remained constant with the year-ago quarter it would have shaved about 2.5 cps off earnings in the June quarter.

More Restructuring Charges Added Back to Non-GAAP

SYY added back 7.7 cps of Restructuring and Transformational Project Costs in the quarter, up from 3.7 cps in the previous quarter. Management talks at length about the productivity investments it is making and calls them out as one-time. The following table shows figures from the company's investor presentation in the various categories it breaks them down into for the last few quarters:

	7/2/2022	4/2/2022	1/1/2022	10/2/2021	7/3/2021
Snap Back Costs	$29	$35	$73	$57	$36
Productivity Costs	$41	$30	$40	$0	$0
Transformation Costs	$67	$48	$44	$24	$51
	$137	$113	$157	$81	$87
Rest. & Transform Project Costs (non-GAAP adj)	$39	$19	$23	$25	$33

"Snap Back" costs were first called out in the 10/21 quarter and labeled as "Short-Term Transitory Expenses Associated with Business Recovery". That quarter, the company even added these costs back to a second layer of earnings adjustments on top of the first layer of non-GAAP adjustments in its earnings presentation. This practice disappeared after that quarter- we don't know why. These Snap Back costs relate to expenses such as replacing all the employees it laid off during the pandemic.

Transformation costs relate to the company's "Recipe for Growth" strategy to improve its IT capacity and other enhancements to its business. Meanwhile, the Productivity Costs line appeared in the 4/22 earnings call slides and retroactively included the $40 million in the 1/22 quarter which was not present on that quarter's slide deck. These amounts represent more investments in the company's business model.

To be clear, only the "Restructuring and Transformational Project Costs" line is added back to non-GAAP earnings and those amounts likely include spending that is included somewhere in the three top categories. However, we find it interesting that the non-GAAP add-backs do not seem to be very correlated to the total spending in those three categories, and we are unclear as to what qualifies an expense to be ignored by non-GAAP results.

We understand that that company is investing heavily in its business now and the overall level of spending could come down to the benefit of fiscal 2023's earnings. But here's our big problem-

SYY's restructuring charges added back to adjusted results long predate any of these categories listed above and years before the pandemic. Every quarter for the last five years has featured a restructuring charge with an average amount of 11 cps. To be clear the charges extend much further back than five years, that's just as far as we cared to look for this writeup. We follow few companies with a track record for material charges that are that predictable. So, calling out these charges as "one-time" or implying they are not operational does not make sense to us.

Teva Pharmaceutical Industries Limited (TEVA)
Earnings Quality Update

We are reducing our earnings quality rating of TEVA from 3- (Minor Concern) to 2- (Weak).

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

Summary

TEVA has been cheered for working toward more litigation resolutions. When the company is meeting or beating estimates, investors seem to be forgetting that TEVA will need to pay billions of dollars in settlements. These payments will occur regularly over 15 years. These obligations are accruing as new liabilities on the balance sheet – **yet TEVA is adding back its legal expenses as non-recurring items and producing a huge amount of Non-GAAP EPS:**

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Legal Cost	$729	$1,124	$604	$3	$6	$104	$50	$21
NonGAAP EPS	$0.68	$0.55	$0.77	$0.59	$0.59	$0.63	$0.68	$0.58
Beat/Miss	$0.12	$0.00	$0.04	-$0.06				
Legal EPS	$0.54	$0.83	$0.45	$0.00				

TEVA has been guiding to a 17%-18% tax rate so we just used that to estimate the amount of Non-GAAP EPS generated by adding back the legal costs. So, on this one item, TEVA reported adjusted EPS of 68 cents in 2Q22 which beat forecasts by 12 cents but it picked up 54 cents by adding back legal bills. For 1Q22, it met forecasts of 55 cents but added back 83 cents for legal costs.

The EPS items don't end there. We have talked often about how TEVA has been drawing down sales allowances for years and this is generating EPS too:

	2Q22	1Q22	2021	2020	2019	2018
New Sales Allowance	$3,382	$3,088	$13,426	$14,415	$16,767	$18,899
Allowance Used	$3,309	$3,522	$14,009	$15,750	$17,319	$20,069
Net change	$73	-$434	-$583	-$1,335	-$552	-$1,170
EPS Impact	-$0.06	$0.32				
Ending Allowance	$3,880	$3,807	$4,241	$4,824	$6,159	$6,711
% Gross Sales	13.6%	13.3%	14.5%	15.5%	18.3%	18.1%
% Net Sales	25.1%	24.5%	31.6%	33.5%	36.7%	35.5%

The declining allowance helped 1Q22 by 32 cents for both GAAP and non-GAAP. That likely set up 2Q22 to see a small headwind of 6 cents. Look at how much these allowances have declined. We think this could still be a sizeable headwind as insurers and governments push for lower prices on drugs.

What else has helped/hurt EPS so far in 2022:

- After guiding to an effective tax rate of 18%-19%, 2Q22 came in at 7.7%. This added 8 cents to 2Q22 Non-GAAP EPS.
- R&D without stock compensation fell y/y in both 1Q and 2Q and generated 2 cents in EPS for both periods.
- SG&A without stock compensation declined y/y for 2Q and added another 2 cents in EPS.
- Lower depreciation helped 1Q by 1 cent and hurt in 2Q by 1 cent.

Litigation is pushing up debt again too:

TEVA's earnings story is that it produces lots of EBITDA and can pay its debt down. Yet, litigation accruals are rising and raising net debt. Plus, TEVA's free cash flow is much lower than EBITDA to service this debt:

	2Q22	1Q22	4Q21
Legal Accrual	$3,928	$3,762	$2,710
Net Debt	$20,024	$20,742	$20,878
Total	$23,952	$24,504	$23,588
EBITDA	$1,134	$1,135	$1,373
Cash Ops	$123	-$49	$456
Cash from Securitizations	$287	$305	$370
Asset Sales	$18	$25	$43
CapX/Acquisitions	-$127	-$164	-$153
Free Cash Flow	$301	$117	$716

- Free Cash Flow routinely is less than half EBITDA, it hasn't been more than 45% of EBITDA in years.

- TEVA's definition includes asset sales and pulling in cash from receivables.

- Many of the expenses that TEVA adds back to Non-GAAP EPS consume some cash.

- TTM EBITDA is $4.8 billion. TEVA would argue Debt to EBITDA is 4.2x based on the $20.0 billion. However, we'd argue the growing legal accrual would push it to 5.0x. Plus, EBITDA is declining too.

Impairments are continuing as well:

We have noted in the past that TEVA hasn't made a sizeable acquisition in several years and Goodwill peaked at $44.4 billion. From 2016, the goodwill balance is now $18.8 billion after another $745 million impairment in 2Q22. TEVA is continuing to take impairments on other intangibles too with another $199 million in 1H22. We are seeing weaker earnings, more litigation charges, and TEVA is also blaming higher discount rates to value these assets.

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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