BEHIND THE NUMBERS
Quality of Earnings Analysis
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BTN Thursday Thoughts

Updates and New Developments on Active BTN Ideas

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AT&T Inc. (T)
Earnings Quality Update

We are maintaining 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 also raised revenue growth forecasts at Wireless – its largest unit - from 3%+ to 4.5%-5.0% for 2022. It also cut Free Cash Flow forecasts from $16 billion to $14 billion. It beat 2Q22 adjusted EPS forecasts of $0.65 beat by 3 cents. We consider that a strong beat given several headwinds that impacted results:

- Bad debt expense rose by $130 million, costing it 1.3 cents.

- It lost $100 million from delayed government payments along with inflationary pressures in the Business Wireline unit costing it 1 cent.

- The end of FirstNet and CAF II reimbursements were known events coming in as well as some ARPU headwinds from 3G retirement that were not quantified. AT&T said the first two were $100 million, or 1 cent, of lower EPS. 3G's headwind was not defined. Adjusted EPS still beat and were up y/y.

- AT&T said inflation is running $1 billion above its 2022 guidance and some part of that was a headwind or 2Q22 too – every $100 million is a penny of headwind. That was not in 2Q guidance.

- AT&T also accelerated spending to gain new customers. It is running ahead of its guidance on mobility customers and fiber broadband. Adding the new customers required more capital spending and also more marketing, customer service, and technician labor than forecast too. This was not quantified, but these were also costs that exceeded guidance for 2Q.

What Was Strong

- The revenue guidance raise impacts Wireless, which is two-thirds of total revenue. It grew postpaid customers at a 4.6% rate and total subscribers and connections at a 6.1% rate. Broadband revenue guidance was left at 6%+ even though the goal to reach 70 million POPs for 5G and fiber footprints by the end of 2022 was met in 2Q22. Now the goal is to reach 100 million POPs by the end of 2022.

- AT&T beat forecasts despite the many headwinds noted above. Now there are many tailwinds in place for the rest of 2022 and beyond:

    - ARPUs are rising, customers are opting for more premium plans and roaming fees are starting to return. Two quarters ago, roaming fees were still basically zero and premium plan customers for wireless were only about 15% of the total so there is room for much more growth in these areas. AT&T also expects some of

the government spending delays to be resolved, which resulted in revenue pressure at Business Wireline in the first half of 2022.

- AT&T is also boosting some prices to cover inflation pressures and there are promotional broadband plans that will roll off later this year and result in higher prices too. Simply offsetting some of the inflation should boost earnings.

- Setting up new infrastructure and getting initial customers in new areas involves more upfront costs and costs per user. Since AT&T has already exceeded its goal of new location set-ups, it should be able to build increased usage at these existing sites at a lower cost per new user. Also building additional locations involves less effort as John Stansky noted too on the call:

  *"I think it's probably intuitive to you. But just to remind you, **the first 100 million POPs in wireless coverage are very different than the next 100 million POPs, just in terms of kind of capital intensity and what has to be done to make them happen** on the number of physical sites you have to touch. So if you want to think about this, it would not be right to kind of straight-line level of activity and investment as you make your journey to covering most of the United States."*

- Early 2022 included expenses related to turning off 3G networks, writing off assets, removing some equipment, moving customers to new plans, or losing some. That is now over and should become a tailwind going forward as 3Q21-early 2Q22 quarters with expense and disruption compare to future periods without those issues.

- AT&T expects to ultimately realize $6 billion in annual cost savings, largely related to retiring copper lines. It achieved $3 billion in savings at the end of 2021 and expects to reach $4 billion by the end of 2022. Thus far, much of these savings have been applied to new investments such as HBO Max roll out when it owned WarnerMedia and paying for accelerating broadband, fiber, and 5G roll-outs too. AT&T noted on the earnings call that it expects to see some of those cost savings flow to the bottom line in 2H22 and beyond.

- From an earnings standpoint, interest expense should decline too. At the end of 1Q22, net debt was $169 billion. It was $132 billion at the end of 2Q22. That is $1.5 billion in annualized tailwind from lower interest expense. The dividend is $8 billion per year and free cash flow forecast at $14 billion will allow debt to decline further.

What Was Weak

- The reason AT&T bumped its bad debt reserves up by $130 million is customers are paying more slowly. It expects a $1 billion headwind to free cash flow due to rising receivable balances. AT&T notes the rise in DSOs is about 2 days. The company has seen this happen before in recessionary times and notes that people may be slower in paying – they do still pay to keep their phones turned on.

  It's difficult to see this with Covid because AT&T's receivables included several operating units no longer here and we know the Warner revenues were hit by the loss of movie theater and sports revenues which would skew the DSO calculation. But in 2008 and early 2009, we can see that the situation corrects itself:

	2Q09	1Q09	4Q08	3Q08	2Q08	1Q08
Revenue	$30,734	$30,571	$31,076	$31,342	$30,866	$30,744
Receivables	$14,846	$14,965	$16,047	$16,395	$15,921	$15,697
DSO	44.1	44.7	47.1	47.7	47.2	46.6

- FCF forecast was reduced from $16 billion to $14 billion was the other bad news. About half this difference comes from higher A/R. It also comes from inflation of about $1 billion. Plus, AT&T accelerated investments to drive its stronger demand in wireless and broadband. Those higher investments consumed some of the cost savings the company is achieving from its $6 billion multi-year plan. Going forward, the company believes A/R will correct, and by pulling forward some of its investment spending, it will see higher revenues going forward. Plus, it is already forecasting that some of the cost savings will hit the bottom line later this year and it has price increases that should have some impact to offset inflation too. It is not reducing 2023 guidance for these issues and is also pointing out that 3G shutdown costs that impacted 2022 will not recur.

- Business Wireline is falling faster than forecast. AT&T attributes this to government spending delays and inflationary pressures totaling about $100 million. It is guiding to a low double-digit rate of decay this year and is calling for stabilization in 2H24 vs. 2023.

Our view of this is AT&T was already forecasting the decline of legacy Business Wireline for some time. When we did our sum-of-the-parts discussions in past reports we only valued this unit at 4x EBITDA. The company openly discussed this decline during its Investor Day. The longer-term goal is to transition many of these customers into 5G, fiber, broadband, and more of the mobility unit. So some of the losses here are showing up in the higher rate of wireless growth and FirstNet. Even forecasting a double-digit decay rate in EBITDA here, higher business mobility is offsetting some of that. Business Wireline EBITDA is down 11% 1H22 vs 1H21 or $539 million. We know Wireline plus Business Mobility EBITDA is down $476 million and there have been larger investments in mobility in the last two quarters that may moderate going forward. Total Mobility is 4x larger than Wireline in EBITDA terms and is growing despite heavier than planned investment levels.

We won’t spin Wireline decay as a positive, but this trend has been seen for years.

The Coca-Cola Company (KO)
Earnings Quality Update

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

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

Summary

KO's 2Q22 adjusted EPS of 70 cents beat forecasts by 3 cents. It did not raise guidance for adjusted EPS after beating by 6 cents in 1Q22. This latest 3-cent beat did not cause KO to raise EPS guidance either and it also cut the expected loss of Russian/Ukraine-related business from 4 cents in 2002 to 3 cents.

- Depreciation and Amortization declined $61 million y/y and added 1.1-cents. It's also worth noting that with huge price hikes and acquisitions, KO is picking up even more in margin leverage in this area. Depreciation and Amortization was 318bp in 2Q22 vs 536bp in 2Q21 – an increase of 218bp for operating margin. But, adjusted operating margin fell 100bp y/y despite a huge tailwind from Depreciation and Amortization.

- KO continues to reduce bad debt reserves in dollar terms even as price hikes drive up the dollar level of receivables. Bad debt reserves rose with Covid as many would expect. However, they are now below Covid levels with a much larger receivable figure:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Receivables	$4,494	$4,641	$3,512	$3,889	$4,036	$3,762	$3,144
Bad Debt Allowance	$510	$512	$516	$534	$527	$527	$526
Percentage	10.2%	9.9%	12.8%	12.1%	11.5%	12.3%	14.3%

	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Receivables	$3,827	$3,849	$4,430	$3,971	$4,353	$4,888	$3,852
Bad Debt Allowance	$546	$549	$527	$524	$525	$524	$492
Percentage	12.5%	12.5%	10.6%	11.7%	10.8%	9.7%	11.3%

The Covid allowance peaked in 2Q20. Pre-Covid, KO was generally reserving about 11% of receivables and there is some seasonality in 4Q that makes the percentage look higher. At 11%, the reserve would be $550 million which is $40 million higher. This looks like another penny in EPS.

- The reduced forecast of missing Russian sales of 1 cent becomes the rest of the 2Q22's 3-cent beat.

- Inventory continues to be the biggest red flag at KO for us. Normally, DSIs are about 85 days +/- 2 days. It is now at 71 days. We believe KO is avoiding replacing inventory at higher costs. And Inventory in dollar terms is basically equal to 2020 levels, which is absurd given there were deflationary factors, and the inventories were inflated because they were backing up in the supply chain early in Covid.

	2Q22	1Q22	4Q21	3Q21
Adj COGS	$4,634	$4,233	$4,042	$3,908
Inventory	$3,621	$3,741	$3,414	$3,182
DSI	71.1	80.4	76.9	74.1
	2Q21	**1Q21**	**4Q20**	**3Q20**
Adj COGS	$3,904	$3,556	$3,661	$3,508
Inventory	$3,281	$3,356	$3,266	$3,264
DSI	77.3	85.9	86.5	84.7
	2Q20	**1Q20**	**4Q19**	**3Q19**
Adj COGS	$3,038	$3,291	$3,605	$3,717
Inventory	$3,501	$3,558	$3,379	$3,266
DSI	104.9	94.1	89.0	80.0

In early 2021, KO was not even mentioning inflation as a forward factor until 4Q21 and guided to mid-single-digit commodity inflation for 2022. It just raised that forecast to high-single-digit. Its COGS in dollar terms is growing at almost twice the rate of inventory in the last two quarters (19% COGS growth and 10% inventory growth). Units should be falling.

- We believe KO is not raising earnings guidance because even huge price hikes are not offsetting inflation. KO uses FIFO and average cost inventory accounting which should

help during inflationary periods as it sells inventory purchased at lower costs. Yet even with a 12% price increase in 2Q22 – margins are down. Adjusted gross margin declined 140bp and operating margin fell 100bp. Where would KO be without leveraging costs like depreciation and amortization? Where would KO be if it only had an 11% price increase? EPS would have been 2 cents lower with an 11% price hike instead of 12%. Volume figures still look good, and KO boosted organic growth forecasts for 2022 from 7%-8% up to 12%-13% so they intend to take even more pricing. What if pricing goals cannot be achieved AND KO has to replace inventory at higher costs?

- Latin America continues to look squirrely as it is still taking large pricing gains with minimal FX hits. However, this looks likely to end in 3Q as KO has a very tough comp and FX is becoming a headwind again:

Latin America	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Volume Growth	-4%	20%	-10%	11%	29%	2%
Pricing Growth	12%	19%	11%	23%	9%	7%
FX	-1%	-6%	1%	7%	3%	-10%

The drop in volume in 2Q22 was due to timing issues and should bounce back in 3Q. However look at 3Q21- KO took a 23% price increase and enjoyed 7% positive FX for a net 30% jump in pricing. Since then, it's been 12%, 13%, and 11%. 3Q22 could see a much more subdued result for Latin America which has been a key part of KO's reported organic growth.

- We also want to remind investors that KO could be required to post over $4 billion in cash if it loses its tax case on transaction splitting with the IRS. That case remains on hold until the tax court resolves a similar case involving 3M. We saw that Natalie Olivo wrote in *Law360.com* on July 15, 2022, that the 3M case is one to look for in 2H22. We do not know anything more than that on this front, but it remains a risk to keep in mind.

International Business Machines Corp (IBM)
Earnings Quality Update

We are maintaining our earnings quality rating of IBM at 2- (Weak).

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

Summary

We have the IBM 10-Q for 2Q22 and we believe there are several areas where IBM made its earnings with unsustainable items. Just to recall, IBM's adjusted EPS of $2.31 beat by 2 cents. It typically files its 10-Q/10-K reports more than a week later when investors have moved on from its earnings report and presentation. We have to write an update for IBM twice as a result, with the second update able to focus more on information in the actual filing.

We believe there were over 20 cents net of minor headwinds in one-time or short-lived sources of EPS in IBM's 2Q. Some of these will reverse in 3Q too. Here is what we saw in the 10-Q:

- We saw that Adjusted Other (Income) and Expense had a huge increase y/y in 2Q from $16 million in income to $418 million. IBM pulls out all items related to retirement and Kyndryl for the adjusted figure. We see that it still included a $232 million pretax gain on the divestiture of its healthcare software assets. This is classified in "other" within the Other Income. This is a one-time item and depending on whether it was taxed at 21% or IBM's effective tax rate of 16.4% - this added 20-21 cents to EPS.

- On the call, IBM claimed it took the opportunity of this gain to book losses on stranded assets for $75 million and noted that the gain offset $100 million of losses to wind down the Russian business. That still leaves $57 million of gain that won't recur, which is still 5 cents in EPS for a company that beat by 2 cents.

- As we expected, IBM benefitted again from lower workforce rebalancing in SG&A. This charge declined from $107 million to $28 million y/y and that $79 million was worth 7 cents in EPS for 2Q22.

- It is important to remember that workforce rebalancing is unlikely to be a source of profits in 3Q22 or 4Q22 as it had a $0 there for 3Q21 and a $60 million credit for 4Q21:

Workforce Rebalance	4Q	3Q	2Q	1Q
2022			$28	$5
2021	-$60	$0	$107	$94

- We are sticking with our estimate that of IBM's 421 million y/y drop in depreciation, only $349 million was due to spinning off Kyndryl (that was Kyndryl's depreciation in 1Q22). We won't have Kyndryl's results until August 3. That $72 million difference added another 7 cents to EPS.

- Related to depreciation falling, we noted that Kyndryl had only $180 million in capital spending in 1Q21 and 1Q22 and $752 million for all of 2021 and no spending on capitalized software. Yet, IBM's investment in these areas is falling more than that:

	2Q22	2Q21	1Q22	1Q21
Capital Spending	$339	$560	$281	$494
Cap. Software	$172	$204	$169	$175

- One headwind for EPS was bad debt expense moving to $6 million in expense from a -$22 million credit for y/y for 2Q – that cost IBM 2.6 cents in EPS.

- Another headwind was stock compensation rising $10 million y/y and cost 1 cent in EPS.

- We will point out again that IBM just reported almost flat R&D in dollar terms before stock compensation at $1.615 billion up $24 million or 1.5% y/y. Yet gross margin was down 200bp, despite sales rising 10.8%. The reason for the margin decline was rising labor costs. Why isn't R&D being impacted by that too? The discussion in the 10-Q was R&D was up 4% and fell back 2% from FX. This still looks like an area where IBM picked up at least 3 cents in EPS during 2Q22.

- We noted last week how much of IBM's sales growth is due to deals involving Kyndryl. It is worth noting that of IBM's retained 19.9% stake in KD – it sold half of it in 2Q to retire a credit line in November. It will either pay cash to settle this if the shares are below $13.95 or will be paid additional cash if KD is above $13.95. That is not a material amount

of money – but IBM sure isn't hanging on to shares in the company it remains very closely aligned with for future growth.

- Also of note, IBM lost a lawsuit to BMC Software on May 30 for $718 million. IBM's comments are that it has no exposure to this because it was related to Kyndryl:

  IBM 2Q22 10-Q:

  > *"As disclosed in the Kyndryl Form 10 and subsequent Kyndryl public filings, in 2017 BMC Software, Inc. (BMC) filed suit against IBM in the United States District Court for the Southern District of Texas in* ***a dispute involving IBM's former managed infrastructure services business.*** *On May 30, 2022, the trial court awarded BMC $718 million in direct damages and $718 million in punitive damages, plus interest and fees. The judgment will be appealed****. IBM does not believe it has any material exposure relating to this litigation. No material liability or related indemnification asset has been recorded by IBM.****"*

  However, Kyndryl believes it wasn't the party being sued and IBM needs to deal with it.

  From Kyndryl 8-K filed May 30, 2022:

  > *"The Company is not directly named as a party to this matter, but has previously included disclosure about the matter in its filings with the Securities and Exchange Commission because the matter raises allegations about IBM's managed infrastructure business, which IBM contributed to the Company in connection with IBM's spin-off of the Company."*
  >
  > *On May 30, 2022, the trial court issued an opinion dismissing several of BMC's claims and awarding BMC $717 million in direct damages and $717 million in punitive damages, plus interest.* ***This judgment is against IBM. IBM has publicly stated that it plans to appeal the judgment because it believes that the judgment is contrary to the facts and the law, and intends to seek a complete reversal on appeal.*** *The Company also understands that IBM plans to seek a stay of any final judgment entered by the court while the appeal is pending.* ***IBM may seek an indemnity from the Company in connection with the matter.*** *Until there is a final and conclusive judgment in the case after appeals and proceedings*

are concluded, until the amount of any applicable insurance is determined, and ***until a definitive assessment of Kyndryl's indemnity obligations (if any) occurs, which in the aggregate will likely take several years, the amount of any indemnity obligation that the Company may owe to IBM is indeterminate."***

Texas Instruments Incorporated (TXN) Earnings Quality Update

We are maintaining our earnings quality rating of TXN at 5+ (Strong).

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

Summary

TXN's adjusted EPS of $2.52 beat by 37 cents. After guiding revenue down from $4.9 billion in 1Q22 to $4.2-4.8 billion for 2Q22 reflecting the shut-downs in China – TXN hit revenue of $5.2 billion. Because much of the cost structure at TXN is fixed, that additional revenue leveraged costs and drove the beat.

- The only adjustment to EPS remains the 7 cents for the start-up costs for the plant expected to open in 3Q or 4Q. That 7 cents may disappear partially in 3Q22.

- TXN has pension actuarial losses that rose by $8 million in the quarter and stock compensation rose by $6 million. Combined those were headwinds of 1.3 cents.

- As TXN opens new plants in 2022 and 2023, depreciation on those plants will commence. For the first half of 2022, depreciation was $427 million vs. $363 million and TXN is guiding to $1 billion of depreciation that will increase further in 2023. There could be some lumpiness in margin results in the next few quarters as the depreciation expense jumps instantly with new capacity coming online, but the production of those plants will build over time and the output will grow and become rising revenue over time too.

- Demand in the quarter exceeded estimates and customers wanted all their orders despite the shutdown in China. This led to a back-loaded quarter with receivables increasing. We think the important point is that TXN didn't see cancellations – which has been a fear hanging over the stock. While pointing to weakness in personal electronics, TXN still sees strong demand in all other markets. Also illustrating strong demand is pricing remains higher and TXN still cannot rebuild its inventory to desired levels.

- Inventory finished the 2Q down 2 days despite the shutdowns endured. Their goal is to be closer to 190 days and they are at 126:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
DSIs	126	128	118	114	113	116
Fin Goods DSIs	36	40	37	37	40	44

- We have talked repeatedly that TXN's cost model is largely fixed for R&D and SG&A which makes revenue the wildcard. It is guiding $4.9-$5.3 billion in revenue for 3Q which should continue to leverage costs and preserve margins.

- Free cash flow suffered by $395 million in 2Q22 due to rising receivables with a back-end heavy quarter. We expect that to normalize in 3Q22 and see some of that cash released. Inventories consumed $139 million in the quarter and to the extent TXN can push DSIs closer to 190 days, it will need another $1.1 billion in inventory that will consume more free cash flow. That is unlikely to happen all in one or even three quarters given the trouble it has had fulfilling current demand and growing inventories already. But, it should not surprise investors to see this as a continued headwind on free cash flow.

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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