

FIAT LUX PARTNERS

Catalent, Inc. (NYSE: CTLT)

**Public Rebuttal to GlassHouse
Research Short Activist Report**



FIAT LUX

Highlights of our Conclusions

- **Misreading of Financial Statements Results in Incorrect R&D Analysis:** GlassHouse Research's observation that Catalent's R&D has been in decline is, we believe, based on a misreading of Catalent's financial statements. The company amended its classification of R&D between FY20 and FY21, changing its *stated* but not its *actual* R&D spend. Actual R&D spend did not change. GlassHouse's analysis of a decline in R&D and the conclusions drawn from its analysis are, in our opinion, entirely discredited.
- **Mischaracterization of Executive Turnover:** GlassHouse's characterization of the CAO position as a game of "musical chairs" is, we think, entirely out of line and based on faulty facts and assumptions. The role, we believe, is new as of 2021, and has been held by fewer individuals than GlassHouse claims. The lone change in title occurred in mid-2022 when, it appears, an opening in a more senior role gave the then-CAO an opportunity for promotion. GlassHouse's characterization of this change in role as a demotion and a signal of executive instability is, we think, without basis and likely false.
- **Incomplete Inventory Analysis Produces Inappropriate Speculations Regarding Potential Write-Downs and Earnings Quality:** GlassHouse observes that Catalent's inventory has been rising rapidly without acknowledging that effectively 100% of the increase can be attributed to raw materials, which it accumulated to protect against COVID-era supply chain issues amidst a period of rapid growth. GlassHouse's conclusion that Catalent faces a significant inventory write-down due to discounting or obsolescence of its end products is, to us, inappropriate and overblown.
- **Out-of-Context Cash Flow Analysis Gives Unjustifiably Negative Characterization of Catalent's Financial Status:** GlassHouse's characterization of Catalent as in financial "turmoil" due to its decline in free cash flow ignores management's recent additions to capex, which nearly doubled as a percentage of sales in response to 20-25% organic growth since the onset of the pandemic. Free cash flow has been strong on a normalized basis, against historical capex levels. And the working capital concerns to which GlassHouse draws our attention have not weighed on operating cash flow, which remains flat to up – a fact curiously ignored by GlassHouse.
- **Elevated Contract Assets Provided Without Context of Decline in Trade DSO:** GlassHouse's discussion of Catalent's elevated contract assets ignores the attending decline in trade DSO between FY19 and FY22, reflecting a likely shift in sales mix, not an aggressive and intentional "pulling forward" of revenue, as GlassHouse claims. The increase in contract assets is, with few exceptions, not reflected in a decline in operating cash flow, which again remains flat to up, as GlassHouse fails to acknowledge.

Public Rebuttal to GlassHouse Research on Catalent, Inc. (NYSE: CTLT)

Fiat Lux Partners, a team of independent short activists, is issuing a public critical response to GlassHouse Research's recent short report on Catalent, Inc. (NYSE: CTLT).

We believe that GlassHouse's report represents a one-dimensional application of a boilerplate "forensic accounting" checklist which, in many cases, ignores or fails to address important contextual information, financial or otherwise. A more comprehensive review of GlassHouse's claims, attended by the appropriate context, reveals that most of them are not as worrisome as depicted by the report, and that they have demonstrably not had the negative financial impact that the report suggests.

A less selective presentation of the facts enumerated in the report suggests that the financial "turmoil" described by GlassHouse is overblown. And, in several cases, we believe that GlassHouse's observations and claims are plainly and demonstrably false.

We wonder, openly, how someone so versed in "forensic analysis" could have missed so many mitigating factors which, to us, appear clear and obvious.

Further, we believe that GlassHouse draws inappropriate conclusions from its "forensic accounting" analysis regarding management's behavior and intentions. It frequently points to accounting phenomena as dispositive proof of financial wrongdoing by management: that management is "pulling forward" sales by "prematurely recognizing revenue," and has been "using every accounting trick in the book" and "accounting gimmicks" to "aesthetically lift a deteriorating company." We believe that these extremely aggressive claims are offered without evidence, and that the phenomena described can be attributed to more realistic and less sinister explanations.

We believe that, in sum, GlassHouse's report represents an academic exercise in forensic accounting whose observations ignore the critical context that would be vital to determining whether CTLT is a viable short candidate. In a vacuum, these observations allow GlassHouse to "check the boxes" on the customary red flags of a classic forensic accounting analysis. But, in our view, **it applies the "forensic accounting toolkit" so bluntly and mechanically that its findings, lacking context, are frequently meaningless, irrelevant, or entirely contrary to the arguments being made.** Put in their proper context, GlassHouse's claims do not amount to a compelling short case, in our view.

About the Authors

We are independent activist short-sellers, past and present.

We believe in short activism: intelligent and well-incentivized investors are more likely to find instances of financial wrongdoing than are thinly-stretched government employees at the SEC's Division of Enforcement.

We also believe that the activist space has become too crowded, and that low-quality publishers are free-riding on the credibility built up by good and honest activists over the past decade.

The sell-side reports issued in response to activist research are typically cursory, uninformative, and lacking in credibility to the investing public as non-independent evaluations of short-sellers' work.

Yet not all investors have the time, stamina, or requisite level of sophistication to evaluate the claims made by activist short-sellers – much less within the timeframe required to respond to an activist report.

We, as seasoned short-sellers, understand the work that goes into constructing an honest and credible activist short report.

But just as we understand the financial games that some companies play to give the appearance of strong performance, we also understand the tactics used by some short-sellers to manufacture an influential short case.

We intend to publish responses to short reports which we believe to be flawed, in the interest of policing the activist space against low-quality reports and protecting the honest short-sellers whose collective credibility they threaten.

Contact us to learn more.

How to Read This Document

- Read the report highlights above for a concise summary of some of our more significant findings
- To read more about any of our particular findings, look for it in the Table of Contents, and navigate to the corresponding section. Read the **maroon text** under each heading for a brief summary.
- If you'd like to skim for more information, but don't quite want to read the whole document, scan through for the text **highlighted in red**
- If you enjoy a good read, kick back, grab your venti latte, and read the whole thing
- If you want to learn more, contact us

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I. Introductory Remarks

GlassHouse Research begins its short report on Catalent, Inc. (NYSE: CTLT) by stating that its “thesis revolves around the following” (page 3). “The following” is a list of accounting anomalies and observations which GlassHouse finds to be of grave concern. We’d suggest an inverted imagery: it’s the observations that revolve around the thesis, the gravitational center, as it were. But if this is GlassHouse’s “thesis statement” – a list of financial aberrations and abnormalities – we’d ask: what’s at the center of the orbit? What explains these worrisome trends? Unbilled receivables might be growing and inventories might be ballooning, but what does it mean? And why, exactly, should we, as investors, care?

“Financial dark matter,” GlassHouse might say. But good luck getting your PM to short a stock on that.

This, we contend, is a common error among some accounting-driven short theses. GlassHouse dusts off its copy of Howard Schilit’s *Financial Shenanigans*, runs down the list of red flags, checks off enough boxes and – voila – a short report is born. Red flags, however, are merely symptoms of underlying financial illness. Sometimes there’s something grave underneath it all. But the symptoms aren’t fully explanatory: in proper context, they may be perfectly benign.

GlassHouse Research, we believe, offers an account of financial trends and accounting anomalies at Catalent stripped of critical information and context. Its “short report,” in our opinion, amounts to an academic exercise in “forensic accounting” that ignores critical information which renders the supposed “red flags” far less malignant than the reader is led to believe. And, in a number of critical cases, we believe, GlassHouse’s observations and claims are flat-out wrong.

GlassHouse does, in fact, take a stab at identifying the “dark matter” – the true underlying issues – in some cases: it takes the leap of suggesting that Catalent’s accounting anomalies are dispositive proof of financial wrong-doing by management. In so doing, we believe that GlassHouse inappropriately presumes financial impropriety by Catalent management without offering any proof of willful misconduct whatsoever. We believe that it draws reckless conclusions regarding management behavior and intent which cannot be inferred from the evidence provided in any decisive way. In offering these salacious conclusions, we think, GlassHouse depicts a far more concerning picture of Catalent than is justified by the evidence provided, and does so in a way that is unnecessarily alarming to the investing public.

GlassHouse’s analysis, in our opinion, amounts to nothing more than a list of observations regarding Catalent’s financial status which are provided out of context and already known to and understood by the market, sensationalistic speculations regarding their cause which are offered without any proof whatsoever, and a number of claims which are flatly false and entirely discrediting of whole sections of the report.

We do not believe it offers a compelling reason to sell shares of CTLT.

II. Misreading of Financial Statements Leads to Inappropriate Conclusions Regarding R&D Spend

GlassHouse’s observation that Catalent’s R&D has been in decline, we believe, is based on a faulty reading of Catalent’s financial statements: **reported R&D appears to have fallen between the FY20 and FY21 financials because the company changed how it classifies and reports R&D. There is no evidence, we believe, that actual R&D spending was reduced.** Even then, the conclusions that GlassHouse draws from its erroneous observation are, we believe, without merit when placed in proper context: as Catalent’s M&A activity has remained steady or declined in recent years, it would be difficult to accept the argument that management is only now slashing R&D in favor of acquiring research via M&A.

GlassHouse makes great hay of its observation that Catalent’s R&D spend fell by more than half between FY20 to FY21, from 2.4% of sales to just 0.5% thereafter. This, we are told, is extraordinarily damning: not only has swapping out in-house R&D with accelerated M&A allowed it to shift R&D-related expenses into amortization, enhancing Adjusted EBITDA, but it evokes the business model of the infamous Valeant Pharmaceuticals, which was investigated for price fixing in 2015 and whose executives were convicted of running a kickback scheme through a closely-related distributor. We believe that GlassHouse errs in several critical ways.

a. Analysis of Decline in R&D Based on Faulty Numbers and Misreading of Financials

Firstly, and most critically, GlassHouse’s analysis of Catalent’s R&D is flatly incorrect, we believe. **We think it’s clear that reported R&D costs fell between FY20 and FY21 because the company changed its classification of R&D in its financial statements, and that GlassHouse erroneously interprets this as a decline in actual R&D spend.** In more recent statements, Catalent describes its R&D spend as reflecting costs “primarily directed toward the development of new offerings and manufacturing process improvements.” However, in years including and prior to FY20, it describes its R&D spend as including “costs incurred in connection with research and development services we provide to customers and services performed in support of the commercial manufacturing process for customers,” a seemingly broader definition which, unsurprisingly, produced a higher reported R&D figure. It also reported an additional amount of R&D which was included in SG&A, which it no longer does as of FY21.

FY21 10-K

Research and Development Costs

Our research activities are primarily directed toward the development of new offerings and manufacturing process improvements. Research and development costs amounted to \$21 million, \$21 million, and \$19 million for fiscal 2021, 2020, and 2019, respectively.

FY20 10-K

Research and Development Costs

Our research activities are primarily directed toward the development of new offerings and manufacturing process improvements. Costs incurred in connection with the development of new offerings and manufacturing process improvements are recorded within selling, general, and administrative expenses. Such research and development costs included in selling, general, and administrative expenses amounted to \$2.6 million, \$3.3 million, and \$6.3 million for fiscal 2020, 2019, and 2018, respectively. Costs incurred in connection with research and development services we provide to customers and services performed in support of the commercial manufacturing process for customers are recorded within cost of sales. Such research and development costs included in cost of sales amounted to \$61.2 million, \$51.2 million, and \$46.2 million for fiscal years ended 2020, 2019, and 2018, respectively.

Importantly, we believe that we can be certain that the observed decline in reported R&D reflects a shift in classification rather than a paring-down of actual R&D spend because **the company's reported R&D expenses for FY19 and FY20 changed between the FY20 and FY21 10-K, when its working definition of R&D costs changed.** We believe that it's quite obvious that this can be attributed to the shift in the company's classification of R&D between its FY20 and FY21 financial statements – and, therefore, that the decline in reported R&D through FY22 can also be attributed to the tightened scope of its R&D disclosure, not a decline in actual R&D spending.

Annual Reported R&D Spend (COGS)

	<u>FY18 10-K</u>	<u>FY19 10-K</u>	<u>FY20 10-K</u>	<u>FY21 10-K</u>	<u>FY22 10-K</u>
FY18 Reported R&D	\$46.2	\$46.2	\$46.2	-	-
FY19 Reported R&D	-	\$51.2	\$51.2	\$19.0	-
FY20 Reported R&D	-	-	\$61.2	\$21.0	\$21.0
FY21 Reported R&D	-	-	-	\$21.0	\$21.0
FY22 Reported R&D	-	-	-	-	\$23.0

The apparent “decline” in R&D spend, we think, is clearly a product of revised reporting standards between FY20 and FY21, when reported R&D costs for prior years were revised downward

We believe that GlassHouse's argument regarding Catalent's decline in R&D is predicated on a very basic misreading of the company's financial statements and is entirely discredited. This level of carelessness would cause us, as investors, to further question the credibility of the rest of the report, and to wonder whether the other arguments by GlassHouse are worth heeding in their own right.

b. Conclusions Regarding (Wrongly-Assumed) Decline in R&D Meaningless in Context of Recent M&A Trends

Even if GlassHouse’s observations regarding Catalent’s R&D were in fact accurate, we believe that this analysis further exposes the report as an academic exercise in “checking boxes” on financial trends which are frequently taken out of context. GlassHouse argues that the decline in R&D reflects a shift in company spending away from in-house research in favor of acquiring research via M&A, in effect allowing management to capitalize its research spending rather than run it through the income statement, where it would weigh on EBITDA. It should be noted, however, that Catalent’s total spending on acquisitions through recent years has been at most flat, and could be said to be in decline: net spending on M&A through the last three years (\$1,421) is down from its total spending on M&A through the previous three years (\$2,206).



Catalent’s M&A spend during the years in which GlassHouse (erroneously, we believe) observes a decline in R&D was no more aggressive than it was in prior years

If Catalent has not become more aggressive in its M&A activity, could it really be said that management is “swapping out” R&D in favor of acquired research to support its earnings figures?

Sometimes companies do, in fact, pare back their R&D spending for valid reasons, and it cannot immediately be assumed that their doing so is deserving of suspicion. As short-sellers, we would be interested to know if a decline in R&D coincided directly with an increase in M&A activity. And in this instance, even if GlassHouse’s R&D figures were accurate, this cannot be said to be the case. Accordingly, we’d be hesitant to suggest, as it appears to us that GlassHouse does, that a decline in R&D reflects an attempt by Catalent to enhance earnings by exchanging R&D for M&A.

This is all, to some extent, beside the point, as GlassHouse’s premise that Catalent’s R&D is in decline appears to be erroneous from the outset. But we believe that it further reveals what we consider to be the overriding flaw in GlassHouse’s approach: it puts the boilerplate “forensic accounting playbook” to work in a one-dimensional manner, divorced of proper context, and attempts to argue that CTLT is a short simply because it checks the boxes.

A good short report would tell us *why* these observations matter: why for example, they suggest that the company is in distress, or why they imply suspect behavior by management. GlassHouse simply observes (incorrectly, we think) that R&D has declined, and immediately jumps to the “forensic accounting” platitude that it’s likely related to its acquisition of external R&D – disregarding the actual M&A trends that would inform any such inference. Accordingly, the conclusions that it draws from its observed decline in R&D, even if that decline were not merely superficial, would be uninformative and lacking in any empirical foundation, and would contribute nothing of value to a critical short thesis, in our opinion.

c. Inappropriate Parallel between Valeant and Catalent Suggests Either Misunderstanding of Valeant or Sensationalism

It's also worth reflecting upon GlassHouse's decision to draw close parallels between Catalent and Valeant Pharmaceuticals, which famously collapsed following inquiries into its pricing strategy and financial impropriety surrounding Philidor Rx, a closely-related distributor. GlassHouse justifies this comparison by claiming that Catalent "chooses to circumvent R&D expenses on the income statement through acquisitions," and that Valeant was the "poster child" for this approach to earnings management.

Valeant's problems, however, went far deeper than the "circumventing of R&D," and its downfall had little, if anything, to do with the particular accounting consequences of this behavior. Valeant came under fire not merely for being a serial acquirer of specialty pharmaceuticals, but for hiking the prices of acquired drugs by hundreds or thousands of percent, raising both moral and legal concerns. And its executives were shown to have been involved in a kickback scheme by which it would direct customers of Philidor away from cheap generics and towards Valeant's far more expensive drugs.

Lots of companies engage in heavy M&A activity. Not all of them – in fact, likely very few of them – do so to inflate earnings by limiting R&D. You could count on perhaps just one finger the number of companies of meaningful size that have done so with the particular moral and legal questions that attended Valeant's egregious behavior. And the actual fraudulent activity that resulted in convictions among Valeant executives had nothing to do with its M&A in a vacuum.

Why, then, does GlassHouse loudly draw parallels between Catalent and Valeant just because it (erroneously, we think) believes that Catalent's R&D is in decline? Without properly arguing, with a suitable empirical basis, that this represents an attempt to enhance earnings by limiting R&D in favor of accelerated M&A? Which is not in fact accelerating, but is flat at most, as GlassHouse appears to ignore?

We might speculate, based on nothing but the arguments presented, that GlassHouse's decision to compare Catalent to Valeant either reveals a misunderstanding of the particular problems that brought Valeant down, or represents an attempt to go out of its way draw a superficial connection between Catalent and a highly-publicized pariah in the financial world. We don't suggest that either is absolutely the case, but we also believe that either would be highly discrediting, and would give us pause in buying into the rest of what GlassHouse's report has to say.

III. Mischaracterization of Executive Turnover

GlassHouse’s characterization of the CAO position as a game of “musical chairs” is, we think, entirely out of line and based on faulty facts and assumptions. The role, we believe, is new as of 2021, and has been held by fewer individuals than GlassHouse claims. The lone change in title occurred in mid-2022 when, it appears, an opening in a more senior role gave the then-CAO an opportunity for promotion. GlassHouse’s characterization of this change in role as a *demotion* and a signal of executive instability is, we think, without basis and likely false.

GlassHouse draws attention to what it deems to be a concerning level of executive turnover at Catalent. It first highlights the departure of CEO John Chiminski in early 2022. Chiminski’s departure we do not find to be of grave concern: as GlassHouse itself notes, Chiminski spent 13 years at Catalent as CEO (after another 20 years in senior positions at GE). GlassHouse, however, presents Chiminski’s departure as worrisome in the context of turnover among other positions at Catalent. We find this turnover to be mischaracterized, in our opinion, and several of the attending details to be flatly incorrect.

GlassHouse states cavalierly that “there has been a musical chairs going on” with the CAO position at Catalent: after former CAO Thomas Castellano was appointed to fill the vacated CFO role in May 2021, Rickey Hopson was elected to take his place. Just over a year later, in July 2022, he stepped down as CAO to take the position of Division Head for Clinical Development & Supply, which, GlassHouse states, appeared to be a demotion.

We believe that GlassHouse strongly mischaracterizes the supposed instability at the CAO position. The role appears to be brand new as of June 2021, when Hopson was first elected to fill it. Now-CFO Thomas Castellano was never in fact CAO, as GlassHouse states, but served as Global Vice President for Operational Finance prior to being appointed to his current role. We also observe, using the Wayback Machine, that no CAO was listed under Catalent’s executive management team prior to September 2022, when Karen Santiago was appointed to fill the position. While the role existed prior to this, during Hopson’s tenure, we find no record of any CAO at Catalent prior to June 2021.

Item 5.02 Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers.

New Chief Financial Officer

On May 11, 2021, Catalent, Inc. (“Catalent” and, together with its subsidiaries, the “Company”) announced that its board had appointed Thomas P. Castellano as Senior Vice President and Chief Financial Officer, effective June 1, 2021 (the “Effective Date”), succeeding Wetteeny Joseph, who will be leaving the Company in order to become the Chief Financial Officer of Zoetis Inc. Mr. Joseph’s departure is not due to any disagreement with any of Catalent, its board of directors, or its management, and he will not be entitled to receive any payment in connection with his departure other than as set forth in his existing offer letter.

Mr. Castellano, 41, currently serves as the Company’s Global Vice President of Operational Finance, providing finance partnership on strategic execution across the Company’s business units, and as a member of its Executive Leadership Team. He joined the Company as Director for Financial Planning & Analysis in 2008, playing an integral role in Catalent’s successful initial public offering in 2014, and has served in successively senior positions since then, including as Vice President, Financial Planning & Analysis from 2012 until 2016 and Vice President, Finance, Investor Relations, and Treasurer from 2016 until 2020. Prior to joining the Company, he worked with the capital markets finance group at Lehman Brothers, holding roles of increasing responsibility. Mr. Castellano began his career at Cendant Corporation as part of its financial leadership development program. He holds a bachelor’s degree in finance and an MBA, both from Seton Hall University.

Source

Not only do we wonder on what basis GlassHouse assumed that Castellano was previously CAO, but we find its characterization of the CAO position as “a game of musical chairs” to be entirely disingenuous: the role appears to be less than two years old, and to have been filled by only two individuals, no more.

Importantly, we also believe that Hopson’s appointment to the role of Division Head for Clinical Development & Supply was most likely a promotion, not a demotion, as GlassHouse assumes. [Previous iterations](#) of Catalent’s executive leadership webpage show the role of “President, Clinical Supply Services” being held by Ricci Whitlow through mid-2022. As of [September 2022](#), Whitlow is gone, and her role appears to be replaced by or renamed as “Division Head for Clinical Development & Supply,” the position now filled by Hopson.

It appears to us that, in making the choice to “step down” (per the [8-K](#)) from a CAO position that was not highlighted as an “executive leadership” role on Catalent’s website until recently, in order to take a recently-vacated position that was in fact highlighted prominently, Hopson was more likely promoted to his current position, which is also now situated above the CAO role on Catalent’s executive leadership page.

We are completely uncertain as to the basis upon which GlassHouse speculates that this change in role was a demotion, and why it would choose to make such a bold assumption without a clear factual foundation for doing so.

We note that is not our intent to nitpick. We wouldn’t waste your time drawing attention to what we thought were honest mistakes that have little or no bearing on the strength of GlassHouse’s message. But it is clear to us that GlassHouse appears to have gone out of its way to characterize executive turnover in the accounting function as a major problem at Catalent, and that this should be a point of major concern for investors. And the facts upon which it appears to make this claim appear to be at best exaggerated, at worst plainly false.

We believe that these observations are discrediting of this entire portion of GlassHouse’s argument. But, just as importantly, the fact that GlassHouse appears to make such strong and cavalier statements based on claims which appear to be exaggerated, false, or without basis forces us to question both the validity of the rest of the report and the tact with which it was constructed.

IV. Incomplete Inventory Analysis Produces Inappropriate Speculations Regarding Potential Write-Downs and Earnings Quality

The recent increase in Catalent’s inventory balance, discussed prominently in GlassHouse’s report, can be attributed to growth in its raw materials balance, making it unlikely (in our opinion) that management will have to significantly write-down its inventory out of discounting or obsolescence, as GlassHouse claims. Further, GlassHouse’s claim that the rise in inventory balance implies that TTM EPS was boosted by over 25% represents, we believe, a misapplication of standard approaches to forensic accounting analysis, and is without basis.

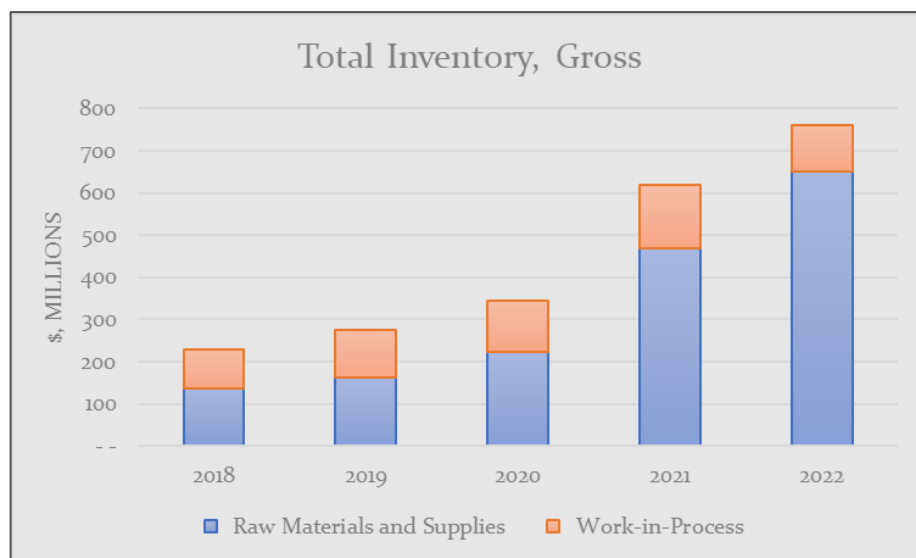
GlassHouse observes that, since Q1 FY20, Catalent’s inventory has expanded from \$259 million to \$732 million, and, with it, its three-month days sales of inventory (DSI) have grown from 48 to 86. It also observes that management recently stated that the company’s inventory balance is “about \$400 million too high.” From this it concludes that Catalent is due for a massive inventory write-down, as “much of this excess balance will need to be discounted or deemed obsolete.”

It further claims that the increase in inventory balance implies that “earnings were boosted” over the relevant period: in particular, had its twelve-month DSI remained steady at 68 from Q1 FY22 through Q1 FY23 – by which point that figure had, in fact, risen to 77 – Catalent’s inventory balance would be just \$605 million, not \$732 million, suggesting that “earnings were boosted by an after-tax \$107.3 million over the TTM (or \$0.59 in EPS, 25.4% of TTM EPS).”

We believe that GlassHouse’s analysis is critically flawed on several counts.

a. Growth in Inventory Balance Attributable to Raw Materials, Making GlassHouse's Speculations Regarding Write-Down Unlikely, in Our Opinion

Firstly, it is inappropriate and incorrect of GlassHouse, we believe, to claim that such a significant inventory write-down is to be expected, as effectively 100% of the increase in inventory can be attributed to its raw materials balance.



Effectively all growth in Catalent's inventory balance can be attributed to raw materials

We think it flatly erroneous of GlassHouse to suggest that “much of this excess balance will need to be discounted or deemed obsolete” when it has been driven not by its finished products balance but by raw materials, including, per the 10-K, “key materials such as gelatin, starch, and iota carrageenan; packaging films; single-use production components for drug substance production, and glass vials and syringes for drug product.”

Catalent is not burdened by a glut finished goods which it cannot sell at current prices. It is, rather, simply sitting on an elevated level of inputs, which it should be able to work through over the coming quarters. Accordingly, we think it highly misguided of GlassHouse to predict a major inventory write-down due to discounting or obsolescence.

You'll also note that nearly all of growth has transpired since the beginning of the COVID-19 pandemic. As GlassHouse itself points out, management has been transparent about its “strategic decision at the onset of the pandemic to increase inventory levels...to allow us to have the inputs we need” amidst pervasive supply chain disruptions, and prior to a period of punctuated growth during which access to such inputs would be critical. Such “supply chain inflation” has been relatively widespread since early 2020, as many companies took similar measures. It is neither unique to Catalent nor suggestive of earnings management in any way.

GlassHouse should have known this had it looked at the footnotes to Catalent's inventory balance, or had it considered management's comments regarding its inventory accumulation more closely. But we know, at the very least, that it was aware of management's conscious decision to increase its raw materials balance in response to the pandemic, as it quoted management's claims to this effect verbatim.

Why, then, would GlassHouse predict that “much of this excess balance will need to be discounted or deemed obsolete” when it was seemingly well aware that the inventory expansion could be attributed to raw materials? We must conclude that it was at best extremely careless in drawing its conclusions from its surface-level observations of Catalent’s balance sheet, turning to boilerplate “forensic accounting” deductions of an expanded inventory balance without taking context into account. At worst, it could have ignored the attending context to present a more ominous picture of Catalent’s financial status.

We do not intend to suggest that GlassHouse did so. We simply point to these two possibilities as the only logical explanations, to our minds, of GlassHouse’s erroneous inferences regarding the likely financial consequences of Catalent’s elevated inventory levels, the causes of which it appears to be cognizant. We have a difficult time squaring its obvious awareness of the driving factors behind Catalent’s enlarged inventory and its forceful conclusion that a significant write-down is likely. We wonder openly why GlassHouse would draw such an inference, and we encourage readers to do the same.

b. Inappropriate and Unreasonable Financial Conclusions Drawn from Inventory Analysis

Secondly, we think it erroneous of GlassHouse to suggest that Catalent's elevated inventory balance implies that "earnings were boosted," and that this line of thinking once again reflects a rigid adherence to a boilerplate "forensic accounting" approach, stripped of relevant and necessary context.

Forensic accountants point to elevated inventory levels as a potential sign of earnings management in cases in which the translation of inventory into COGS is not straight-forward. Howard Schilit's *Financial Shenanigans*, to which GlassHouse makes reference as a source of guidance, uses the example of a film production studio: if a movie costs \$20 million to produce, the studio would expense the associated inventory by \$5 million over four years if it expected the film to generate equal revenue over the course of four years. If, instead, the movie produced revenue for only two years, the inventory balance would have been expensed too conservatively, earnings would have been inflated through the first two years, and the \$10 million remaining inventory balance after those two years would have to be written off.

This example of an inflated inventory balance is not at all analogous to the current situation at Catalent. There is no such obvious ambiguity in its translation of inventory into COGS, and we know, per management, that this is not the source of its inflated inventory in any case: it is simply a consequence of conscious and strategic raw materials management. GlassHouse cannot conclude, as it does so expressly and cavalierly, that the increase in twelve-month DSI from 68 to 77 since Q1 FY22 necessarily implies that "earnings were boosted."

Nor, in our opinion, should its suggestion that the inventory bloat alone had inflated EPS by a massive 25% have passed the smell test for GlassHouse, or for any informed reader: had we performed a similar analysis and reached a similarly extreme conclusion, we would be compelled to think that we had erred in our work, and would be forced to review our assumptions. That GlassHouse published them as-is forces us to conclude either that it was either careless in its analysis or highly aggressive in its presentation of Catalent's financial outlook. We do not necessarily suggest that either is absolutely the case – we merely see these as the only two possible explanations for GlassHouse's claims.

To infer that Catalent's elevated inventory necessarily implies "boosted earnings" is, to our minds, to apply the prescriptions of forensic accounting in a blindly mechanical and careless manner. GlassHouse, we believe, conducted and compiled its "short report" as a mere exercise in checking boxes on customary accounting red flags, not as a thoughtful exploration of why observed financial dynamics at Catalent – all things considered – may be of legitimate concern to investors. Accordingly, we do not consider GlassHouse's claims as supportive of a legitimate short thesis of any sort, and we do not see them as providing any rationale for selling or shorting shares of CTLT.

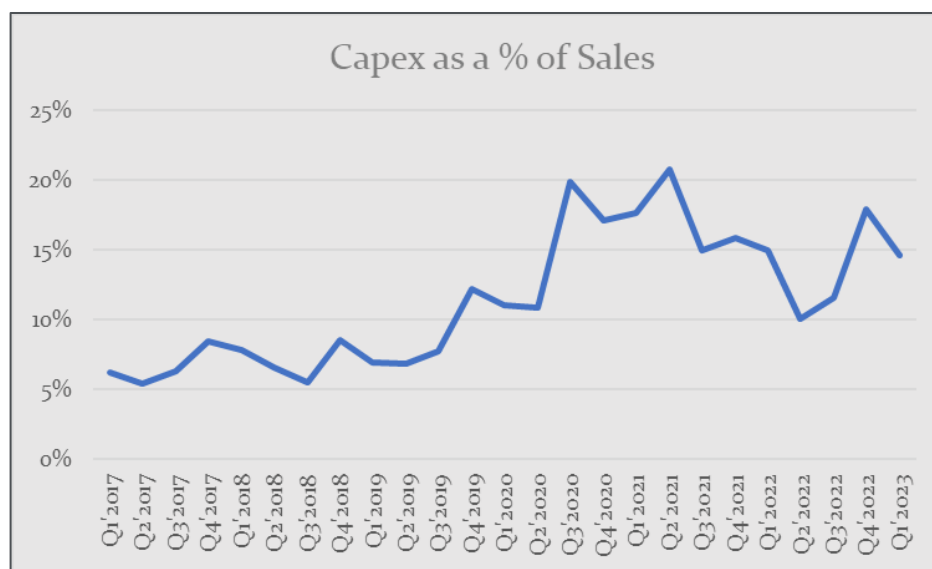
Accounting exercises can be informative. But, ultimately, as short-sellers, we must think like investors – not merely, and not only, as accountants. We'd advise that GlassHouse reflect upon this before issuing another "strong sell opinion."

V. Out-of-Context Cash Flow Analysis Gives Unjustifiably Negative Characterization of Catalent's Financial Status

GlassHouse suggestion that Catalent's weak free cash flow since FY20 reveals a company in "turmoil" fails to take into account management's increase in capex from <10% of sales to >15% of sales over the same period, a response to its strong organic growth over the same period – contradicting GlassHouse's claim that Catalent has resorted to M&A because it has "run out of options to organically grow the company." FCF was lower due to management's conscious decision to prioritize growth, not financial weakness. GlassHouse's decision to highlight Catalent's superficially-weaker FCF number in place of its stronger OCF figure to paint a picture of "turmoil" is, to us, out of line with its claims throughout the report that working capital items such as inventory and contract assets represent serious problems weighing on company financials.

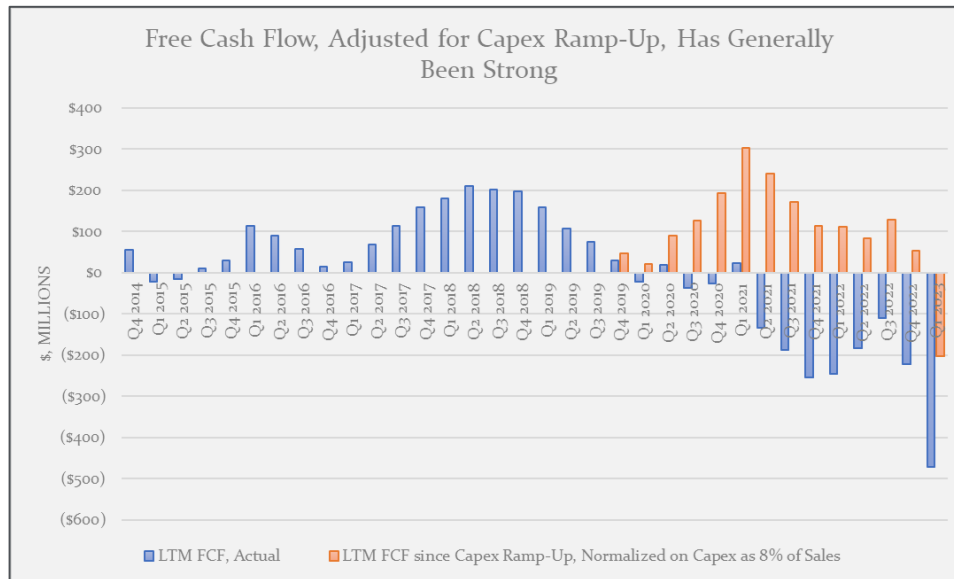
GlassHouse claims that Catalent's free cash flow figures suggest that "the company is in turmoil," pointing out that the company has been consuming cash through the last several years as it has faced increasing "contract asset and inventory issues," and that it "run out of options to organically grow the company." Free cash flow has been so anemic, we are told, that management now plans to rein in capex to combat the bleed. Is this in fact the case?

Let's begin with the final claim: management did indeed express its intention, during its most recent earnings call, to reduce capital spending to 10-11% of revenue, down from ~15% since the beginning of FY20. However, we believe that it would be grossly disingenuous to characterize this as a mere cutting back of capex: in FY20, management made the conscious decision – and announced loudly to investors – that it would be increasing capex to a mid-teens percentage of revenue for "the next two to three years." Today, just shy of three years following that statement, management is now reducing capex to 10-11% of sales – right on schedule, and to a level still above its historical average of ~7% of sales.



Catalent capex was routinely below 8% of sales until only recently, when capital spending was accelerated around Q4 FY19

Normalizing capex to its historical average reveals that, under previous spending patterns, free cash flow would have indeed been quite strong since the recent ramp-up in capital spending (with the exception of last quarter, the reasons for which have already been addressed by management and are well understood by investors, and which do not represent new revelations brought to market by GlassHouse). And operating cash flow has been flat to up over the same period (again excepting the most recent quarter), which GlassHouse ignores (see further discussion below). We see little in Catalent's free cash flow pattern to suggest that Catalent has been "in turmoil" through the past several years, as GlassHouse brazenly claims.



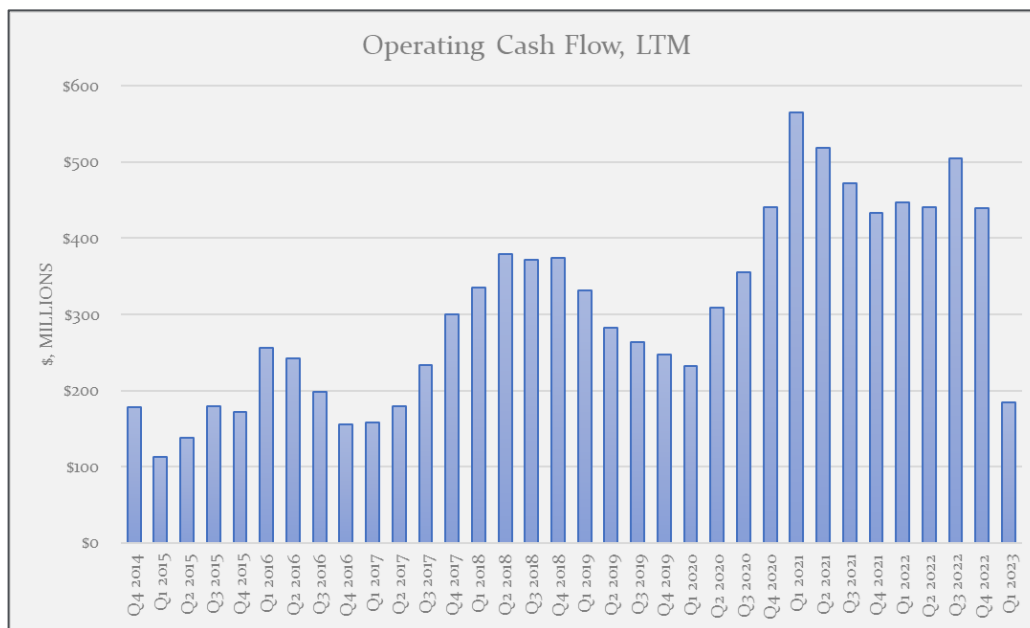
To suggest that management is slashing capex out of financial distress, we think, is either misleading or revealing of a failure on GlassHouse's part to understand the context of Catalent's capital spending patterns, about which management has been entirely transparent.

Why, you might ask, did management decide to increase its capital spending so markedly above historical norms FY20? Against what backdrop did this occur? Between FY19 and FY21, organic revenue growth expanded from 2% to 25%, and remained elevated at 20% through FY22, largely due to >30% organic growth in its Biologics segment, in which it has been investing heavily. This not only explains the elevated capital spend, but flies in the face of GlassHouse's claim that Catalent has "run out of options to organically grow the company." And the recent downtick in organic growth in the most recent quarter is largely due to a difficult comp against a period in which demand for COVID-19-related items was high.

To us, GlassHouse's claim regarding Catalent's organic growth seems plainly out-of-line with demonstrated company results. While the company has made selective acquisitions, M&A contributed only 3% and 5% to net revenue growth in FY21 and FY22, respectively. To suggest that management has been acquiring aggressively because it has "run out of options to organically grow the company" is, once again, either to reveal a failure to read Catalent's financial statements, in which organic growth is made explicit and unambiguous (with an unusual – and, to us, heartening – level of transparency), or simply to omit critical context in the presentation of its arguments and data. Once again, we do not definitively suggest either to be the case – we simply see these two possibilities as the only logical explanations for GlassHouse's claims.

We also take issue with GlassHouse’s decision to highlight free cash flow in particular as a sign of Catalent’s “turmoil.” Throughout the piece, GlassHouse highlights working capital trends as the most concerning developments taking place at the company: contract assets are rising, contract liabilities are falling, and inventory is through the roof, raising serious concerns as to Catalent’s earnings quality. **Should working capital indeed be its primary concerns, it should point us to operating cash flow, not free cash flow, as the true arbiter of Catalent’s financial health. Doing so would have left it with little ammunition for its argument: again, operating cash flow has been flat to up through the years to which GlassHouse draws our attention, decelerating only in the most recent quarter, for, again, widely-understood reasons.**

To instead point us to a downtrend in free cash flow, the decline in which can easily be explained but which GlassHouse fails to do, is for it to either misunderstand its own arguments or to point us to figures which are more supportive of its cause. Again, we neither know which nor insinuate either to be the case – we only don’t know what else we could logically conclude.



Catalent operating cash flow has been consistently strong despite GlassHouse’s concerns regarding working capital trends

VI. Elevated Contract Assets Provided Without Context of Decline in Trade DSO

GlassHouse highlights the rise in Catalent’s contract assets without also showing the parallel decline in trade DSO, which has been clear and consistent until only recently. Its conclusion – for which, we think, it provides no proof – that management is intentionally “subjectively recognizing revenue prematurely,” is in our opinion unnecessarily aggressive. The decline in trade DSO provides important context which could provide alternative explanations for the rise in unbilled receivables which, we think, are more realistic and less damning of management.

GlassHouse highlights the recent surge in Catalent’s contract assets – or unbilled receivables – as a major cause for concern. This, we are told, is a sign that, in GlassHouse’s opinion, “management is subjectively recognizing revenue prematurely in the revenue recognition process.” Can we be so sure?

Firstly, we believe that GlassHouse, in its interpretation of the recent trend in contract assets, leaps to extreme and unwarranted conclusions for which it lacks proper evidence. A sharp increase in unbilled receivable DSO can, indeed, be cause for concern, as a matter of both credit risk and earnings quality. GlassHouse, however, not only states that it has no misgivings over counterparty risk, but moves beyond mere speculation in its reflections on earnings quality, instead jumping to extraordinary inferences regarding management’s behavior. GlassHouse states, in no uncertain terms, that it believes that “the persistent rise in contract assets at Catalent” suggests that management “prematurely recognize(s) revenue on their own income statement to hit sales targets,” and that it is a clear sign of a “pulling forward” of sales.

It perhaps would have been appropriate for GlassHouse to reflect on the implications of rising contract assets in its proper place, and within the scope of a discussion of earnings quality. **But to state so aggressively that an elevated unbilled receivable balance, in itself, is conclusive proof that “management is subjectively recognizing revenue prematurely in the revenue recognition process” is both incorrect and reckless, we believe.**

We also take issue with GlassHouse’s presentation of the rise in contract assets, which we believe is divorced of important context which may provide less dramatic explanations for Catalent’s elevated unbilled receivables. In particular, it documents the rise in contract assets since Q1 FY20 without taking note of the trend in trade receivables – a far larger component of the company’s total receivables balance (\$989 million, as of Q1 FY23, versus a \$461 million contract asset balance). **We note that, while contract asset DSO have been rising since early FY20, trade DSO have been in steady decline over the same time period, with the exception of the most recent two quarters. Even then, trade DSO are no higher today than they were in FY19, before the recent uptick in contract assets, which has already been addressed on earnings calls, and about which GlassHouse offers no new information to investors.**



The rise in contract asset DSO, until only recently, coincided with a decline in trade DSO, perhaps suggesting mix shift, not a premeditated “pulling forward” of revenue. Even now, trade DSO are no higher than they were in FY19.

This suggests an alternative explanation for the rise in contract assets: rather than representing an explicit “pulling-forward” of revenue by management, it may simply reflect a shift in revenue mix towards items booked on a percentage-of-completion basis. Indeed, management itself says as much, stating (most recently in Q1 FY23) that the rise in contract assets can be attributed to large development programs in the Biologics segment, which, per management, saw 80% organic growth in FY21 and 34% organic growth in FY22 – far above total company organic growth of 25% and 20% in FY21 and FY22, respectively.

We would be surprised if GlassHouse simply neglected to evaluate the recent trend in trade DSO and total DSO, as it has in many of its past reports. We only ask why it chose not to present its analysis of the rise in contract assets against the decline in trade DSO – which, we believe, provides critical context for understanding the trend in Catalent’s contract asset balance – and why it chose to jump to such extreme and accusatory explanations for the rise in unbilled receivables. **We think a more comprehensive and thoughtful analysis of recent developments in Catalent’s receivables balance would have provided a more intellectually complete depiction of Catalent’s financial status, and would allow readers to arrive at far less disturbing conclusions regarding the implications of these developments for management’s behavior and character. GlassHouse’s far narrower presentation and more aggressive discussion, we think, leaves investors much more likely to come away with extreme concerns regarding Catalent – both regarding its financial state and the trustworthiness of its management team – which may not be justified.**

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