BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers 1Q '22 Focus List Part Two
Top Buys and On Deck Buys

Top Buys

Company	EQ Rating	Date Added	
Air Lease Corporation (AL)	4+ (Acceptable)	12/4/2021	p. 4
AT&T Inc.(T)	4+ (Acceptable)	3/12/2021	p. 6
LyondellBasell Industries N.V. (LYB)	*5+ (Strong)*	7/14/2021	p. 8
Mowi ASA (MHGVY)	*4+ (Acceptable)*	12/4/2021	p.10
National Instruments Corporation (NATI)	*5+ (Strong)*	3/12/2021	p.12
Starwood Property Trust, Inc. (STWD)	*5+ (Strong)*	2/8/2022	p.13
Texas Instruments Incorporated (TXN)	*5+ (Strong)*	3/12/2021	p.15
United Rentals, Inc. (URI)	*4+ (Acceptable)*	12/13/2021	p.17

On Deck Buys

Company	EQ Rating	Date Added	
Lamb Weston Holdings (LW)	5+ (Strong)	10/12/2021	p.19

Summary of Changes to the 1Q'22 BTN Focus List During the Quarter

Added to Top Sells

The Coca-Cola Company (KO)	Added 3/30/2022
Ecolab Inc. (ECL)	Added 3/30/2022
Post Holdings, Inc. (POST)	Added 3/30/2022

Removed from Top Sells

Equinix, Inc.	Removed 3/30/2022
Kimberly-Clark Corporation (KMB)	Removed 1/27/2022

Removed from On Deck Sells

Ball Corp (BLL)	Removed 2/28/2022
Eaton Corp. (ETN)	Removed 3/30/2022
Stanley Black & Decker, Inc. (SWK)	Removed 3/30/2022

Added to Top Buys

Starwood Property Trust, Inc. (STWD)	Added 2/28/222

Removed from Top Buys

UnitedHealthcare Group Incorporated (UNH)	Removed 3/30/2022

Overview of the BTN Focus List

Our foundational belief at Behind the Numbers is that earnings quality matters. We believe that companies that are resorting to increasingly aggressive accounting such as slashing reserves, taking never-ending restructuring charges, or extending depreciable lives to meet earnings estimates will eventually face a day of reckoning in the form of an unexpected earnings disappointment. Likewise, companies with hidden assets, conservative accounting, or non-operational headwinds that will reverse are likely to produce better than anticipated results. This has been borne out time and again by academic research.

While our Earnings Quality ratings express our level of concern with the reliability and sustainability of a company's reported earnings and cash flows, they do not consider more fundamental factors such as valuation, sources of recent revenue growth, upcoming difficult comps, or other factors which might make an idea timelier. The *BTN Focus List* addresses this by documenting which companies under coverage we believe are getting closer to the point of materially underperforming or overperforming.

The list is divided into Top Sells and Buys along with an "On Deck" list of companies we believe have compelling points but may not warrant being on the top lists due to valuation factors. We will continue to publish the Focus List quarterly and will notify clients of the additions and subtraction to the list made during the quarter by e-mail.

Top Buys

Air Lease Corp. (AL)- Buy

Date Added	12/4/2021
Market Cap	$5.1 B
Target Price	$66
PE (fwd)	9.6
Short %	3.0%
Current EQ Rating	4+ (Acceptable)

- AL's adjusted EPS of $1.75 in 4Q21 beat forecasts by 52 cents. It saw its only aircraft sales for 2021 in 4Q and added as much as 21 cents of EPS. Delays in new plane deliveries from Boeing and Airbus had slowed AL's normal business of selling more used planes as they reach 7-10 years old. Thus, aircraft trading has been largely missing from AL's income for much of 2020 and 2021. It now expects to see more volume in this area for 2022 – but it will remain lumpy.

- Another $30 million in lease revenue (26 cents in EPS) hit in 4Q from the end of lease payments and those five planes were placed with different airlines. This again is a normal part of AL's operating model that had been missing in 2020 and much of 2021. More signs of normalcy returning.

- In our view, the market is getting past Covid issues and the deferred rent is now being collected. 99.3% of rent was collected in 4Q21. Cash lease collections also rose to $12 million in the quarter. These are customers where rent is not recognized until cash arrives. This has continued to improve since Covid and lease deferrals were heaviest. This added about 10-cents in total, but it wasn't zero before 4Q21. About 5 cents was incremental.

- As the issues with aircraft manufacturing correct themselves, AL should be in a position to resume its full operating model which involves buying and placing about $6 billion in planes annually and selling a large number too to recycle capital and generate trading revenue. For the last two years, it has been running at $3-$4 billion, and AL reduced aircraft sales as a result. It is worth noting that 4Q's $1.2 billion in new purchases were one-third of 2021's totals, so that is a positive sign.

- AL is a finance company that has seen its balance sheet only about two-thirds deployed the last two years with $1 billion of excess cash and balance sheet capacity acting as drags on results. We noted AL has two options – wait out the Covid and travel restrictions with subpar earnings until the recovery begins, or reduce debt and share count to right-size the balance sheet to fit the smaller size of the operation. AL chose the first path and earnings are recovering. We think under either path, AL could see EPS top $5.00 per share, so the stock is trading for 60% of book and about 7x EPS.

- The market was scared over Ukraine and Russian exposure. We are much less concerned. The region is less than 5% of AL's total fleet, several are older planes with lower value, many Ukrainian planes were flown out of the country at the start of the war, and much of the planned business was impacted by delivery delays from Boeing and Airbus. Some contracts call for AL to deliver 7-9 planes to various customers with 0-2 actually with the airline now. As those new planes arrive, we think AL could easily deliver them to non-Russian airlines. We think the total risk to book value is between $5-$8 vs. the current value of over $61. That would require the Ukrainian planes to be lost too, which seems less likely. At the end of 4Q21, rent was current from Ukraine and Russia (and we believe January rent was collected also). We do expect those planes to convert to recognition of revenue only when cash is received as some of those planes are not flying. That should create a small drag for 1Q22 revenues.

- We still see AL with excess capital using its balance sheet to acquire more planes via sale-leasebacks from customers whose cost of capital is too high and rising vs. what AL is paying. AL is holding over $1 billion in cash and has a cost of capital of 2.79% now with 95% of that fixed rate. It will continue to receive new planes from Airbus and Boeing on a delayed basis. We also believe AL will see higher growth as deliveries reach higher levels and customers sell AL some of their fleet and lease the planes back.

AT&T Inc. (T)- Top Buy

Date Added	3/12/2021
Market Cap	$170.8 B
Target Price	$40
PE (fwd)	7.7
Short %	1.0%
Current EQ Rating	4+ (Acceptable)

- The Discovery transaction with Warner may close in late April. Basic stats are 0.24 shares of Discovery for every AT&T share = 1.73 billion along with Discovery's current 663 million shares - 2.4 billion shares at $25. That means $6 for each AT&T share and values Discovery at 8.1x trailing EBITDA of $7.9 billion for Warner and $3.8 billion for Discovery with about $53 billion in combined debt.

- We believe the value of the Discovery shares could double. The EBITDA for both Warner and Discovery are impaired for heavy investment in roll-outs of streaming services that occurs ahead of revenue streams. Discovery is focusing on $3 billion in cost synergies from consolidating overhead reaching EBITDA of $14 billion for 2023. That does not look like a reach as 2019 showed Warner at $9.7 billion and Discovery at $4.7 billion. 2021 was supposed to be Discovery's peak investment for roll-out and Warner's is 2022 – just having that spending decline should help too. At 10x EBITDA (assuming no debt reduction) would make Discovery shares worth $36.25 or $8.70 per AT&T share. At 12x, it's $48 per Discovery share or $11.50 per AT&T share.

- The accounting looks clean at Discovery. We see some financing lease principal payments that would lower EBITDA by $65 million. It sped up the amortization of content costs which is more conservative and could impact some assets at Warner after the completion of the merger.

- When we first wrote AT&T, one of the things that excited us on their primary telecom business was the retirement of copper phone systems. AT&T has been operating two systems the fiber/tower/wireless system and the original copper-based landline system. Copper is expensive to maintain, it requires electricity, it cannot carry the same amount of capacity as fiber and the number of customers using copper is declining so those costs per unit are going up. The FCC streamlined copper retirement to allow the telecom companies to devote more of their spending on new systems noting that eliminating copper saves telecom companies $45-$50 per house per year. AT&T is pointing to $6

billion in cost savings by 2023 with about half already achieved. Copper assets are expected to fall by 50% by 2025 and will help fuel those cost savings. AT&T is also turning off and removing 3G assets on towers that will reduce lease expense. Another $3 billion in cost savings over the next two years adds 33 cents to EPS. Reducing debt through the Warner deal, free cash flow, and cash on hand should reduce interest expense by another $2 billion and add another 22 cents to EPS.

- The pension plan is now benefitting from an uptick in interest rates. The discount rate rose 30bp and the total underfunded level fell from -$7.6 billion to -$2.8 billion in 2021. AT&T should be producing pension income in 2022 and not requiring cash contributions.

- We expect some noise and possible lost wireless customers when AT&T turns off the 3G network. Offsetting that are: AT&T continues to see more customer growth overall with FirstNet and will have a deal to bundle with DISH that ramps up in 2Q22, low roaming fees are likely still impacting results for at least 50 cents per month in ARPU or about $0.5 billion per year, and they are still seeing customers upgrade to higher ARPU plans with only 15% there now.

- Investors are getting AT&T stock for $17 + $6 of Discovery Stock or just under 6x stand-alone EBITDA. There is a 3-year plan in place to retire another $24 billion in debt with free cash flow after the dividend. Without any multiple expansion, that would add 20% to the stock price ($3.33). If they achieve their $3 billion in cost reductions, that should add another $2.50 to the stock price or 15% at 6x EBITDA. They have seen solid growth in wireless customers and have pricing avenues there with upgrading subscribers to higher ARPU plans and roaming fees normalizing. There should also be growth from the fiber roll-out over through 2025 with more subscribers coming onboard during that time. We expect copper savings to continue helping earnings beyond the current forecast for an additional $3 billion in cost savings forecast by 2023. Plus, there's still a 6% dividend with ample coverage annually. It doesn't take too much forecasting to see the $17 stand-alone AT&T price doubling if the company trades for 7x EBITDA (and historically north of 8x had been common in the industry). Warner has traded at 12x EBITDA in its past, and that could almost double the price of Discovery shares coming to AT&T investors. We see this as too cheap to ignore and getting paid 6% with the potential for investment to double over 2-3 years.

LyondellBasell Industries N.V. (LYB)- Top Buy

Date Added	7/14/2021
Market Cap	$34.6 B
Target Price	$160
PE (fwd)	6.9
Short %	1.6%
Current EQ Rating	5+ (Strong)

We continue to see LYB as a company that primarily has only two earnings quality issues – marking inventory to the lower of cost or market and potential impairments. LYB has been considering strategic alternatives for its refinery (including a sale). In 4Q21, it took a $624 million impairment to write down the refinery which cost it $1.45 in non-cash earnings.

Overall, we still LYB as a very cheap stock at 5.0x EBITDA and 5.5x EPS. It continues to hold an operating cost edge over many of its foreign competitors. Base EBITDA is $8 billion now and should increase to over $9.0 billion with new projects coming online in the next year. It will still have commodity price moves, but the amount of free cash flow is very high, and it is rewarding shareholders. This includes paying down $4 billion of debt in 2021 and debt is now 1.2x EBITDA. That also includes 8% dividend growth and a 4.5% yield that consumes $1.5 billion. That includes retiring 44.5% of the stock since 2013 and that used just under $0.5 billion in 2021.

- Demand remains so strong, LYB is still finding it difficult to rebuild inventories. In dollar terms, they are flat, but sales and COGS are increasing so DSIs are going down.

	4Q21	3Q21	2Q21	1Q21	4Q20
Inventory	$4,901	$4,982	$4,840	$4,632	$4,344
DSIs	40.9	45.0	50.9	55.1	$59.1

- LYB expects to see some cost moderation, which should reduce the cash flow pressure from growing working capital. In 2021, working capital used just under $1 billion. Having that reverse in 2022 should provide even more cash from operations. That should enable more cash to be returned via share repurchases and dividends. In addition, LYB repaid $4 billion of debt in 2021 and does not expect that to recur. The dividend may grow this year again.

- The company still hopes to acquire the other 50% of its Louisiana JV with Sasol, which may consume some of that untapped cash flow, which would improve the base level for EBITDA further.

- LYB's Advanced Polymer unit has heavy exposure to auto manufacturing, which has not been running at full steam. Much of that is tied to supply chain issues with semiconductors. Looking at TXN and NATI, we think that is starting to improve and could give LYB a tailwind for that division.

- 2022 is expected to see higher than normal maintenance for much of the industry, which should keep supplies tight. LYB believes it will benefit from that and see continued strong demand and pricing.

- LYB has three new projects turning on in 2022, which should further drive growth through the year.

Mowi ASA (MHGVY)- Top Buy

Date	12/4/2021
Market Cap	$12.3 B
Target Price	$34
PE (fwd)	
Short %	-
Current EQ Rating	4+ (Acceptable)

- MOWI's capital spending will remain elevated with a strong focus on building automation projects (less labor) and freshwater pens so fish spend less time in saltwater (less biologic problems, treatment costs as well as allowing more fish to use current saltwater pens and thus boost harvest volume). Some Covid delays on construction in 2021 had capital spending at only €241 million, about €25 million below guidance. Expect capital spending to remain at or slightly above €300 million per year.

- Cash needs are expected to be €750 million in 2022 (Cap-ex €300 million, taxes and interest €165 million, inflation driven increases in working capital €90 million, and €200 million+ for dividends). With pricing still rising as industry volumes are expected to show negative growth in 1Q22 and flat volumes for the year, EBITDA should top €800 million for 2022. Also, Debt is only 1.8x trailing EBITDA.

- MOWI is getting more successful at reducing costs and has pulled out €182 million from operating costs since 2018 with €45 million more in 2021 against the goal of €25 million. It is harvesting more fish with fewer employees thanks to automation investments, it is reducing FTEs and reducing overtime pay, and it expects the freshwater investments to pay off with reduced health treatments. It should also be noted that normally means higher selling prices on the salmon too. EBITDA was €690 million last year, so this is showing some material results in holding down costs. There remain hundreds of small cost improvement programs in the works.

- MOWI's ADR is converted from NOK (Norwegian Krone) to USD. From The start of Covid in spring 2020-mid-2021, the NOK to USD fell from 11.8 to 1 to about 8.25 to 1, fueling appreciation for the ADR. Currently, close to 9 to 1, but Norway is an oil-producing country and may see some currency appreciation. Historically when oil is at $100 a barrel or higher, the NOK can be between 5-6 to the USD. We think this still represents a potential catalyst.

- We still see the drive to expand the size of the US market with both salmon fillets and consumer products, the return of many of the Asian markets as positive long-term demand for MOWI. Demand is expected to outpace supply growth for several years at this point, and MOWI should see a 10% increase in its volume beginning in 2024 as salmon entering the new freshwater tanks are eventually harvested from existing seawater pens. We see this as a longer-term growth story that intends to pay at least 50% of earnings as dividends.

National Instruments Corporation (NATI)- Top Buy

Date Added	3/12/2021
Market Cap	$5.4 B
Target Price	$52
PE (fwd)	19.0
Short %	1.4%
Current EQ Rating	5+ (Strong)

- NATI is playing out as we predicted. Backlog growth peaked at 6 weeks in 3Q21 and then declined one week in 4Q21. This essentially resulted in NATI booking 14 weeks of sales with 13 weeks of overhead costs. We think this continues going forward and a week of backlog becoming revenues is worth 12 cents in EPS.

- NATI has moved to more software sales where inventory is less of an issue. It also has seen inventory levels rise significantly even as sales growth has taken off too. Historically, NATI's operating model involves avoiding out-of-stock situations and it wants to hold 200-240 days of inventory. It has rebuilt inventories even with growing sales and looks to be in good shape to work down the backlog:

	4Q21	**3Q21**	**2Q21**	**1Q21**	**4Q20**	**3Q20**	**2Q20**	**1Q20**
Inventory	$298	$237	$211	$197	$194	$210	$210	$208
DSIs	227.1	218.0	201.2	196.3	167.6	215.4	228.6	231.8
Product Sales	$377	$326	$307	$295	$328	$270	$266	$274
P Sales Growth	15.1%	20.8%	15.1%	7.7%	-1.4%	-11.6%	-11.2%	-1.3%

- The company has continued investing in the business and maintained high levels of SG&A, R&D, and corporate costs even when sales were impaired due to a lack of inventory. Now sales are the wildcard and are leveraging these costs and NATI is seeing rising margins and rising sales:

	4Q21	**3Q21**	**2Q21**	**1Q21**	**4Q20**	**3Q20**	**2Q20**	**1Q20**
Sales	$421	$367	$347	$335	$368	$308	$301	$309
SG&A	$122	$117	$111	$117	$135	$110	$105	$116
R&D	$92	$82	$81	$80	$74	$71	$64	$72
G&A	$33	$31	$30	$33	$37	$37	$29	$26
adjustments					$30	$5		
Costs % Sales	58.7%	62.7%	64.3%	68.7%	58.5%	69.1%	66.0%	69.0%

Starwood Property Trust, Inc. (STWD)- Top Buy

Date Added	2/28/2022
Market Cap	$7.4 B
Target Price	$30
PE (fwd)	11.1
Short %	1.8%
Current EQ Rating	5+

We added STWD back to our Top Buy list as we believe the company could see a new leg-up with rising interest rates and inflation. At $24, the current yield is 8.0%. STWD sold a 20.6% interest in its apartment portfolio in 4Q21, which led to it recognizing a gain of $191 million or 67 cents per share. STWD is still a REIT and must pay out 90% of its income as dividends to retain its tax-free status. That gain consumed the rest of the company's carryforwards to partially shield income from that payout requirement. It also took away the depreciation shield the apartment portfolio used to provide. This could lead STWD to paying special dividends above the current $1.92 per share annually:

- They still own 79.4% of the Woodhouse apartment portfolio in an investment company. STWD now marks it to fair market value, so it can collect cash flow on the investment stake, but it loses the depreciation and interest expense shields in determining GAAP income.

- The most important aspect of the apartment portfolio is rent levels are set by the federal government based on the inflation rate and the median wage in the area and it looks 3-years back. The rent cannot go down. The rent was about $90 million in 2019 before Covid started leading to housing price appreciation in 2020 and shortages of apartments. Plus, there was wage inflation through Covid and after Covid. Inflation has taken off everywhere. STWD believes the $90 million in rent will increase $10 million on average for the next three years. So there is extra cash flow coming to STWD on the investment. However, now it will be discounting back cash flow streams of $90 million, then $100 million, then $110 million, then $120 million… That should create capital gains when they mark the investment to fair market value. Even if higher rates mean they use a larger discount rate – the cash flow stream is growing at 10%.

- STWD's current dividend is $1.92 per share. It is already paying out more than that as GAAP EPS has been $1.52, $1.16, $1.79 in the last three years. GAAP EPS needs to clear $2.13 for STWD. There is no more depreciation on that property, (based on the change occurring November 5 during 4Q on depreciation vs. a full quarter of depreciation under the prior method in 3Q) that would boost EPS by about 12 cents going forward. STWD should still get a positive cash flow impact from the higher rent of $7.94 million or 3 cents that should be cumulative each year (adding 6 cents in 2023 and 9 cents in 2024). If the value of STWD's 79.4% of the investment company rises $50-$80 million per year based on higher rent, that is 16-26 cents. Thus, it appears the

changes regarding accounting for this investment should add 31-41 cents of GAAP earnings per year.

- The majority of STWD's assets are floating-rate. Much of the financing is fixed now. The last time we saw STWD talk about EPS sensitivity for rising interest rates was 2Q19. It noted that 100 bps increase in LIBOR would add 5 cents to annual EPS and 200bp would add 11 cents to EPS. There have been changes to the portfolio since then, but we think that type of EPS gain could still be a reasonable forecast.

- During 2020 and STWD was carrying several hundred million in excess cash to simply boost liquidity. That cash was earning zero for much of 2020 and it appeared it was losing about 8-12 cents in GAAP EPS with that policy. In 2021, the cash levels dropped, and likely finished near target levels – however, that was not true for all of 2021. There may still be 3-5 cents in incremental EPS going forward from this source. It's also worth noting that prepayments have slowed and fundings have been stronger. This should mean that cash is at work for full quarters without gaps in time when it's back at STWD as cash. We can't estimate this as we don't have the data but losing 7 days of interest per quarter on just $1 billion is worth more than 1 cent in EPS.

- Special Servicing is an area where STWD can work out payment issues, restructure loans in commercial loan trusts (mortgage-backed securities). It can also find nuggets of assets it likes and offer to buy them too. This is an area where results are lumpy and payments often occur when issues are finally resolved. The amount of work being done jumped with Covid and some of this should be concluding in the coming quarters. EPS in this segment has already started to grow:

$ in millions	4Q	3Q	2Q	1Q
2021				
STWD Named as Servicer	$94,776	$91,420	$79,100	$80,100
Active Cases	$7,280	$7,321	$8,200	$8,758
EPS from segment	$0.15	$0.11	$0.07	$0.08
2020				
STWD Named as Servicer	$81,080	$81,360	$82,330	$94,700
Active Cases	$8,761	$8,825	$8,038	$5,550
EPS from segment	$0.11	$0.06	$0.12	$0.12

- We don't want to make this sound as though STWD's dividend will jump from $1.92 annually to $3.00. REIT rules require dividends to rise if EPS exceeds $2.13. We believe there is a solid case to be made that there are enough areas that cumulatively could push EPS above $2.13 and there is evidence these trends are already happening. Plus, if it sells other assets and produces gains – that could do it also. Even STWD admits that it has no way to shield higher earnings from causing it to declare special dividends.

Texas Instruments Incorporated (TXN)- Top Buy

Date Added	3/12/2021
Market Cap	$170.6 B
Target Price	$220
PE (fwd)	20.2
Short %	1.6%
Current EQ Rating	5+ (Strong)

TXN beat forecasts by 33 cents in 4Q21. This was primarily due to some incremental capacity increases enabling TXN to fill more of its backlog of orders. For the most part, TXN views its operating costs as fixed investments and the revenue is the wildcard. Order demand has been strong and the cadence for growth of revenue through the year was the earnings driver - $4.3 billion, $4.6 billion, $4.6 billion, and now $4.8 billion for 4Q21. Higher revenue leverages the fixed costs. Revenue guidance for 1Q22 at $4.5-$4.9 billion would be 5%-14% above 1Q21 levels.

- Demand is growing and is broad-based. The bigger issue for TXN and many in the industry has been fulfilling orders, which has caused backlogs to grow. TXN has more capacity coming online in 3Q22 and again in 1Q23. Both new plants should lower manufacturing costs per unit and leverage gross margin too. As inventory recovers, TXN should see higher sales due to current orders and working down the backlog.

- We showed this dynamic last quarter and will update it here. R&D and SG&A costs have been flat in dollar terms per quarter and that continued in 4Q21. But look at how much they have leveraged with revenue recovering:

	4Q21	**3Q21**	**2Q21**	**1Q21**
R&D	$389	$388	$391	$386
R&D %	8.1%	8.4%	8.5%	9.0%
SGA	$404	$412	$425	$425
SGA %	8.4%	8.9%	9.3%	9.9%

	4Q20	**3Q20**	**2Q20**	**1Q20**
R&D	$388	$386	$379	$377
R&D %	9.5%	10.1%	11.7%	11.3%
SGA	$398	$407	$401	$417
SGA %	9.8%	10.7%	12.4%	12.5%

The long-range goal is to have overhead between 20%-25% of sales. It was there for all of 2020 and fell to 19% at the start of 2021, but finished the year at 16.5%. TXN is

forecasting that percentage to rise in the future back to 20% over t-e long-term, but this should continue to help drive earnings in the near term.

- Inventories have stopped falling and actually rose slightly again in 4Q but remain low. We think this remains the biggest short-term issue at TXN.

	4Q21	3Q21	2Q21	1Q21
DSIs	118	114	113	116
Fin Goods DSIs	37	37	40	44
	4Q20	**3Q20**	**2Q20**	**1Q20**
DSIs	125	139	168	147
Fin Goods DSIs	52	62	77	67
	4Q19	**3Q19**	**2Q19**	**1Q19**
DSIs	146	140	145	146
Fin Goods DSIs	66	63	66	63

We calculate inventory DSIs on ending stocks over the last quarter's COGS so our numbers are 1-2 days different than what TXN reports for total DSIs, but we want to focus on Finished Goods also and have both calculations be consistent.

- While inventories have stopped declining against rising sales, TXN's operating model relies on a much higher inventory level of 140-150 days. On the call, management indicated they would like to be near the high end of a range of 130-190 days. Their view is the product doesn't expire and there is a strong ROI to having extra inventory so that they never miss a sale. With many costs being fixed in the short term, the incremental sale drops largely to the bottom line. Thus, as we discussed above, the variable for TXN results is more tied to the revenue line. When they are out of inventory, that hurts sales and deleverages fixed costs. Until the inventory level increases more (especially finished goods), we think TXN could have some volatility to revenues.

- We do think the new plants coming online could skew the inventory figures later in 2022. Raw materials will likely need to be in place before the start-up dates of 3Q22 and 1Q23. After production is up and running, the production costs are expected to be about 20% lower at the new plants. Thus, inventory in dollar terms may look flat, but units are actually higher.

United Rentals, Inc. (URI)

Date Added	12/13/2021
Market Cap	$26.3 B
Target Price	$410
PE (fwd)	13.6
Short %	3.1%
Current EQ Rating	4+ (Acceptable)

URI beat adjusted EPS by 70 cents in 4Q21, reaching $7.39 per share vs. $6.61 in GAAP EPS. The adjustments to EPS continue to be dominated by acquisition items. Adding back amortization of intangibles is still the bulk of that (47 cents in 4Q21 of the 78-cent total). We give URI high marks on earnings quality as it uses short amortization lives. The largest acquisition of 2021 is still being expensed over 5-7 years.

- The biggest area we still believe investors should NOT focus on is debt-to-EBITDA. At the end of 2021, this was 2.16x ($9.54b in debt over $4.4 billion in EBITDA). The issue we have is URI's business model involves buying new equipment and selling it after about 7 years and recycling back into newer equipment. Thus, capital spending is very high and can exceed depreciation. We think this points to depreciation being a cash expense and is not available for debt service.

	2021	2020	2019
Depreciation of Rental Equipment	$1,611	$1,601	$1,631
Purchase of Rental Equip.	-$2,998	-$961	-$2,132
Sales of Rental Equipment	$968	$858	$831
Net impact on Cash Flow	-$419	$1,498	$330

- Obviously, Covid impacted the purchase of new equipment in 2020 and skewed cash flow that year. Normally this is a small negative impact on cash flow. URI is guiding to similar figures for 2022 - $2.9-$3.1 billion in new purchases and having $1 billion in equipment sales. That should net out to -$300 million in free cash flow. Given that spending needs to occur, we would view URI's debt load as being closer to $9.54 billion over $2.5-$2.6 billion in cash flow available or more like 3.7-3.8x EBITDA.

- We do not believe debt is unmanageable, it should simply be viewed as being higher than reported when comparing it to EBITDA. We also consider it a positive that debt has come

down significantly in recent years. URI has it at 3.0x in 2018 and 2.2x in 2021 – which does not have a full year's contribution of the acquisition. By our method of taking the net cash outflow of buying new rental equipment less equipment sold, 2018 looked like a debt ratio of 4.8x and its 3.7x in 2021. It's still moving toward lower total debt.

- Minor points on earnings quality are extending the useful lives of some acquired equipment and in other cases marking up the fair market value of acquired equipment. URI makes frequent acquisitions so these can impact EPS in many years. For 2021, URI earned $22.06 in EPS – and generated 16 cents from extending the life on some acquired equipment and 38 cents from marking items up to fair market value. The quick turnover of equipment well before the useful life is over means URI is still expensing these assets at over 2-20 years and but selling them at about 8-10 years. Selling prices are about 11% of the purchase price. We would argue this faster depreciation largely offsets these two accounting items of valuing acquired assets.

Lamb Weston (LW)- On Deck Buy

We retain LW on our On Deck Buy list and continue to view the company as undervalued. A normalized EBITDA figure of roughly $940 million based on pre-pandemic results leaves the company selling at about 11x EV/EBITDA. However, we leave it off our Top Buy list for now given near-term uncertainty around costs, the uncertainty of the timeframe for a return to pre-pandemic sit-down dining, and the state of next year's potato crop.

- Gross margins improved sequentially in the 11/21 quarter as price increases and cost reduction initiatives began to take effect. More price increases in December should begin to be felt over the 2/22 and 5/22 quarters, although the company warned that raw materials cost inflation will worsen in the 5/22 quarter. Management narrowed its outlook for gross margin for the year ended 5/22 to 18-20% from its previous outlook of 17-21%.

- This year's potato crop marked the second terrible year in a row for yield which left the company exposed both to having to purchase more potatoes at higher-than-contracted spot rates as well as reducing the output per potato which drives up cost. The company warned that the impact of the bad crop will worsen in the second half of the fiscal year (ended May) and echo into fiscal 2023. Management indicated it will give more color on the outlook for next year's crop in the 2/22 quarter conference call.

- LW has halted sales of products into and out of Russia which negatively impacts its Lamb-Weston/Meijer joint venture as well as negatively impacting the available market for potatoes. This appears to be priced into the stock but this is an area to look for more color in the upcoming earnings call.

Explanation of EQ Rating Scale

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

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

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

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

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

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

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

Key Points to Understand About the EQ Score

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

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

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