BEHIND THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers 1Q '23 Focus List

Top Risks

Company	EQ Rating	Date Added	
Altria Group (MO)	2- (Weak)	6/11/2021	p. 4
Cloudflare, Inc. (NET)	3- (Minor Concern)	7/8/2022	p. 6
The Coca-Cola Company (KO)	3- (Minor Concern)	3/30/2022	p. 8
Dentsply Sirona Inc. (XRAY)	2- (Weak)	4/10/2023	p.10
International Business Machines Corporation (IBM)	2- (Weak)	3/12/2021	p.13
Iron Mountain Incorporated (IRM)	1- (Strong Concern)	12/4/2020	p.15
Keurig Dr Pepper Inc. (KDP)	2- (Weak)	12/4/2020	p.17
Mohawk Industries, Inc. (MHK)	2- (Weak)	9/27/2022	p.20
Post Holdings, Inc. (POST)	3- (Minor Concern)	3/30/2022	p.22
Sealed Air Corporation (SEE)	2+ (Weak)	12/4/2020	p.24

On Deck Risks

Company	EQ Rating	Date Added	
Becton, Dickinson and Company (BDX)	3- (Minor Concern)	4/10/2023	p.26
Cintas Corporation (CTAS)	3- (Minor Concern)	12/2/2022	p.27
Medtronic plc (MDT)	3- (Minor Concern)	4/10/2023	p.28
Teva Pharmaceuticals Industries Ltd. (TEVA)	3- (Minor Concern)	12/13/2021	p.29

Top Values

Company	EQ Rating	Date Added	
Air Lease Corporation (AL)	4+ (Acceptable)	9/27/2022	p.30
Air Products and Checmicals, Inc. (APD)	4+ (Acceptable)	4/10/2023	p.32
AT&T Inc.(T)	4+ (Acceptable)	3/12/2021	p.34
Costco Wholesale Corporation (COST)	*5+ (Strong)*	12/2/2022	p.36
DocuSign, Inc. (DOCU)	*4- (Acceptable)*	4/10/2023	p.38
LyondellBasell Industries N.V. (LYB)	*5+ (Strong)*	7/14/2021	p.41
Philip Morris International (PM)	*4- (Acceptable)*	4/23/2023	p.43
Starwood Properties Trust, Inc. (STWD)	*5+ (Strong)*	2/8/2022	p.45
Texas Instruments Incorporated (TXN)	*5+ (Strong)*	3/12/25021	p.47
United Rentals, Inc. (URI)	4+ (Acceptable)	12/13/2021	p.49

On Deck Values

Company	EQ Rating	Date Added	
Ball Corporation (BALL)	3- (Minor Concern)	9/27/2022	p.51
Otis Worldwide Corporation (OTIS)	5+ (Strong)	7/8/2022	p.53
The Scott's Miracle-Gro Company (SMG)	4- (Acceptable)	9/27/2022	p.55
Stanley Black & Decker, Inc. (SWK)	3- (Minor Concern)	4/23/2023	p.57
Warner Bros. Discovery, Inc. (WBD)	3- (Minor Concern)	9/27/2022	p.58

Summary of Changes to the 1Q'23 BTN Focus List

Added to from Top Risks

Dentsply Sirona Inc. (XRAY)	Added 4/10/2023

Removed from Top Risks

Conagra Brands, Inc. (CAG)	Removed 4/10/2023
The Hershey Company (HSY)	Removed 4/10/2023
Okta, Inc. (OKTA)	Removed 4/10/2023
Sysco Corporation (SYY)	Removed 4/10/2023

Added to On Deck Risks

Becton, Dickinson and Company (BDX)	Added 4/10/2023
Medtronic plc (MDT)	Added 4/10/2023

Removed from On Deck Risks

Mondelez International, Inc. (MDLZ)	Removed 4/10/2023

Added to Top Values

Air Products and Checmicals, Inc. (APD)	Added 4/10/2023
DocuSign, Inc. (DOCU)	Added 4/10/2023

Removed from Top Values

Ares Capital (ARCC)	Removed 4/10/2023
National Instruments (NATI)	Removed 4/10/2023

Added to On Deck Values

Stanley Black & Decker, Inc. (SWK)	Added 4/10/2023

Removed from On Deck Values

Air Products and Checmicals, Inc. (APD)	Removed 4/10/2023

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 Risks and Top Values 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 Risks

Altria (MO)

Date Added	6/11/2021
Market Cap	$79.4 B
PE (fwd)	8.8
Short %	0.89%
Current EQ Rating	2- (Weak)

MO's 4Q22 adjusted EPS of $1.18 beat by 2 cents. Guidance of 3%-6% 2023 EPS growth fueled by another $1 billion share repurchase that should drive 2%+ of that forecast. As MO spends the cash it receives from Philip Morris (PM) as quickly as it comes in, it may be opening another hole in the boat.

- The IQOS patent issues were not ruled on until November 29, 2001, so 4Q21 still had at least two months of spending for the IQOS rollout – that was 1.5-2.0 cents in EPS in expense that didn't occur in 4Q22.

- MO added back 1.2 cents in litigation costs to EPS in 4Q22 and a drop in tax rate added 0.8 cents. Litigation is a recurring expense.

- Pension income in the 4Q was flat y/y at $31 million vs. $33 million. We are surprised the interest cost assumption only moved from 2.0% in 2021 to 2.5% in 2022. Even another 50bp would have cost MO about 0.5 cents in 4Q22. The discount rate to determine PBO rose from 3.0% to 5.6%, so we would expect to see a higher interest cost assumption in 2023. This could add a $150 million headwind to 2023 earnings – about 6 cents per share.

- The menthol ban in California only started on December 21, 2022 – 10 days of 4Q22. It's now a full headwind for all of 2023. California smokers may have stocked up before the ban too, minimizing volume loss in 4Q. The federal government continues to move forward with a national ban on menthol and cutting nicotine levels in cigarettes.

- There is another $100 million writedown in the value of JUUL due to higher discount rates (and likely a review of weaker future cash flows). That reduces the value to $250 million from the original $12.8 billion.

- Auditors are watching for impairments at *Skoal* moist snuff too and list this as a critical audit matter. *Skoal's* trademark is $3.9 billion and most of the $5.2 billion goodwill at MO is for oral tobacco products. Volume is decaying here too. Even MO was talking about using higher discount rates to value assets just like it did with JUUL.

- Volume losses continue to accelerate for MO as tobacco volumes were down 11% in 4Q22. Even management sees headwinds in 2023 from higher prices impacting smokers and they even admit people are smoking less. We believe investors should wonder about the risk of volumes breaking harder as MO continues to boost prices to offset volume losses.

- Philip Morris (PM) may be able to speed up the rollout of IQOS in the US because it does not have to worry about cannibalizing a traditional cigarette market like MO did. Now, PM can grab market share without regard to a partner trading 100% profit on cigarettes for a share of heated tobacco sales. History shows PM can take share quickly with heated tobacco. Can MO handle a large gap down in cigarette volumes in late 2023-2025 on top of its losses to higher prices?

Cloudflare, Inc. (NET)

Date Added	7/8/2022
Market Cap	$19.5 B
PE (fwd)	Na
Short %	7.6%
Current EQ Rating	3- (Minor Concern)

NET's 4Q22 adjusted EPS of 6 cents beat forecasts by 1 cent. It reported a 6.1% adjusted operating margin – a large improvement. We're not sure the beat is completely solid and guidance is not very strong with 1Q23 expected to post 3-4 cents in EPS and a 4.0-4.3% operating margin:

- Stock compensation added 2 cents more to adjusted EPS than in 3Q22.

- Higher interest income added 2.2 cents to EPS in 4Q. Interest income is real money but it's not operating income and no one is paying the multiple NET is trading for to collect interest income.

- Cash spending for R&D and Sales & Marketing increased in dollar terms after dropping in 3Q but still came in below normal levels as a percentage of sales by at least 200bp. That would account for 1.5 cents of EPS:

	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Cash R&D	$49.4	$46.4	$46.2	$40.3	$37.0	$32.8
Cash S&M	$113.0	$103.5	$103.9	$89.7	$86.0	$77.6
Sales	$274.7	$253.9	$234.5	$212.2	$193.6	$172.3
R&D %	18.0%	18.3%	19.7%	19.0%	19.1%	19.0%
S&M %	41.1%	40.8%	44.3%	42.3%	44.4%	45.0%

- The 6.1% adjusted margin is expected to decline 200bp for 1Q23 guidance and for the full year of 2023.

- Even with solid deferred revenue growth, sequential sales growth continues to decline, and the sales forecast of $290-$291 for 1Q23 points to growth falling under 6%:

	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Seq. Sales Growth	8.2%	8.3%	11.1%	10.1%	12.4%	13.1%
Seq Def Rev Growth	27.9%	11.1%	18.5%	13.2%	24.9%	14.7%
Def Rev Days Sales	77.2	65.3	63.1	58.2	57.6	51.8

- Free cash flow was a positive $33.7 million in 4Q22. Normally, NET cannot even report positive cash from operations without adding back stock compensation. We still consider 4Q22 less than impressive for several reasons.

	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Cash from Ops	$78.1	$42.7	$38.3	-$35.5	$40.6	-$6.9
Capital Spend	$40.1	$41.9	$37.1	$24.5	$28.3	$28.8
Software Spend	$4.3	$5.4	$5.6	$4.5	$3.6	$4.0
Free Cash Flow	$33.7	-$4.6	-$4.4	-$64.4	$8.6	-$39.7
Stock Comp	$62.6	$55.9	$57.5	$41.8	$42.1	$28.0
Def. Rev Growth	$50.3	$17.4	$25.5	$16.0	$24.2	$12.4
Int. Income	$8.3	$3.9	$1.6	$1.1	$0.7	$0.4

  - Normally deferred revenue adds $15-$25 million to cash from operations. It was $50 million in 4Q. If that was a normal $15-$25 million, cash from operations again would have been less than the stock compensation.
  - Interest income is now 10% of cash from operations.
  - Capital spending on both equipment and software is down.

The Coca-Cola Company (KO)

Date Added	3/30/2022
Market Cap	$271.9 B
PE (fwd)	25.6
Short %	0.57%
Current EQ Rating	3- (Minor Concern)

KO's adjusted 4Q22 EPS of $0.45 met forecasts and was flat y/y. On earnings quality, we consider this a miss. Guidance for only 7%-8% revenue growth before a 3% FX headwind does not look very strong.

- **The tax dispute appears to be coming closer to an end and we believe this could have negative implications for growth in 2023.** The IRS challenged KO's taxes over the allocation of costs and profits between US and foreign units. The Tax Court was delaying a decision until after the resolution of a similar case involving 3M. A decision against 3M was reached on February 9, 2023, and KO expects the court to soon issue a ruling on its case. KO has warned in past 10-Ks that to appeal it may have to post $4 billion in cash- that is now up to $5.2 billion. In the latest 10-K, KO points to $9 billion in dispute and that with penalties and interest, it could be $14 billion. KO only has $423 million accrued. Free cash flow guidance is for $9.5 billion in 2023 and the dividend is $8.0 billion. KO may not be buying many shares if it has to post considerable cash for this appeal. That would be a headwind for guidance.

- **Pension is turning to a headwind**. Pension income was down to $16 million from $51 million for a 0.7-cent headwind. Guidance calls for pension income to go from $124 million in income for 2022 to a $40 million expense in 2023 – starting 2023 with a 3-cent headwind.

- **The boost from marketing cuts is likely over**. KO claims it is spending more on marketing, up $221 for the year - but prepaid marketing was down y/y by 2%. All of the increase in marketing for 2022 happened in 3Q where marketing expense was up $278 million. For 4Q, advertising declined $170 million y/y adding 3.2 cents to EPS.

- **Capex is rising which will end the benefit of lower depreciation.** Depreciation and amortization fell by $34 million – about 70% of the decline is depreciation – adding 0.6 cents to EPS.

- **Stock compensation fell by $18 million y/y, adding 0.3 cents to EPS.**

- **KO may be stocking up on inventory at an inopportune time**. Inventory in 4Q ramped up by 10 days and is back to normal levels. However, now KO is saying it will be harder to take pricing and it will need to spend more on promotion. A lack of pricing could squeeze gross margin as KO runs higher cost inventory through the income statement with FIFO and Average Cost accounting policies.

- **Latin American pricing less FX is driving a material amount of EPS.** Every 500 bps that pricing exceeds FX headwind generates 1 cent in EPS. We believe this will revert to a normal relationship. In 2018, Latin America had 10% pricing and -9% FX. In 2019, it was 13% pricing and -10% FX. Covid really destroyed the relationship with 2% pricing for 2020 with -14% FX. In 2021 and 2022, this has been abnormal:

Latin America	**4Q22**	**3Q22**	**2Q22**	**1Q22**	**4Q21**	**3Q21**	**2Q21**	**1Q21**
Volume Growth	6%	6%	-4%	20%	-10%	11%	29%	2%
Pricing Growth	26%	12%	12%	19%	11%	23%	9%	7%
FX	-7%	-6%	-1%	-6%	1%	7%	3%	-10%

Dentsply-Sirona Inc. (XRAY)

Date Added	4/10/2023
Market Cap	$8.5 B
PE (fwd)	21.1
Short %	5.5%
Current EQ Rating	2- (Weak)

XRAY's adjusted 4Q22 of $0.46 beat forecasts by $0.13. Investors should remember that 4Q21's EPS was $0.83 with some very questionable contributors. Also, XRAY cut 4Q22 guidance after missing 3Q22 forecasts by $0.17.

- **Inventory still looks bloated.** That does not bode well for gross margins or sales. DSI's are at record highs and XRAY just reported lower sales in every unit. It wants to cut SKUs and said on the call it is discounting and reducing prices in some areas:

DSIs	**4Q**	**3Q**	**2Q**	**1Q**
2022	134	134	129	120
2021	100	109	112	110
2020	91	115	176	143
2019	109	133	130	139
2018	102	136	124	144
2017	114	127	121	126

- **Changing the metric to evaluate results is seldom a sign of improving earnings quality.** XRAY is switching to adjusted EBITDA over adjusted EBIT. We have watched XRAY grow earnings via falling depreciation and warned of underinvesting. New management plans to invest in IT Systems now which should boost deprecation, so the company is pulling depreciation out of the metric.

- **Where is the top-line growth?** This is supposed to be a long-term growth story with population growth, emerging markets growth, aging populations needing more dental care, and a surge in aligners. This metric also changed in 2020 when XRAY stopped adjusting for precious metals price fluctuations in organic growth which should have been an effective price increase. Also, there have been three price hikes between 4Q21 and 4Q22 – but organic growth is only up 2.6%?

	4Q22	4Q21	4Q20	4Q19	4Q18	4Q17
Sales	$983	$1,103	$1,082	$1,112	$1,060	$1,091
Y/Y Change	-10.9%	0.6%	-2.6%	4.9%	-2.9%	9.5%
Org./Internal Chg.	2.6%	1.8%	-3.3%	8.4%	-0.1%	5.3%

- Stock compensation was $12 million in 4Q22 vs -$6 in 4Q21 – a 6.7 cent headwind for 4Q22. Stock compensation fell $8 million in 3Q and a quarterly expense figure of $19-$22 million is common. **One could argue the $12 million is still light by $3-5 million or a 1-2 cent boost to EPS in 4Q22.**

- R&D at $43 million already came in $2 million light as given their goals and sales guidance, XRAY should have budgeted at least $45 million. The decline from $49 million in 4Q21 to $43 million is something we won't poke holes in. We know that 4Q21's R&D figure of $49 million was nonsense because XRAY reclassified non-R&D costs that already occurred in earlier quarters of 2021 into 4Q21 R&D so it could claim it reached its spending goals. In reality, XRAY missed the R&D spending guidance in 2021. In its restated SEC documents, XRAY reversed this gimmick so we do not view the $49 million figure from 4Q21 as real.

- **Adjusted SG&A declined sequentially by $6 million – adding 2 cents to EPS.** However, XRAY is touting that it will invest more in commissions, computer systems, and more people which will drive up SG&A. Reducing the workforce will not impact the sales team and after 3Q results, it said it was hiring more people in sales.

- **The tax rate forecast rose by 100bp after 3Q. The mid-point would have been 23.5% but it came in at 22.7% adding $4.5 million to 4Q results, or 2 cents.**

- **Depreciation was down another $1 million. Inventory reserves actually rose by $6 million and bad debt reserves by $5 million. In total, that is 3.7 cents of headwind.**

- Warranty expense declined from $44 million in 2021 to $27 million in 2022, but it's not clear how much of that was in 4Q.

- **There is a new restructuring plan to save $200 million annually by cutting the workforce. That would be worth about 70 cents in EPS.** This makes expected core profit growth look anemic when one considers that in a troubled 2022, XRAY just posted $2.09. Yet, the goal is only $3.00 in 2026 after four more years of stock repurchases which have already added about 5 cents to EPS in the last five years. The company posted EPS of $2.78 in 2016 and $2.66 in 2017. It originally guided to $3.05-$3.25 for 2022. This still does not look like a growth company.

International Business Machines Corporation (IBM)

Date Added	3/12/2021
Market Cap	$118.4 B
PE (fwd)	13.7
Short %	2.8%
Current EQ Rating	2- (Weak)

IBM missed forecasts in 4Q22 by 1 cent. We found several items that make this look worse.

- Extended warranty new deferrals were a credit of $3 million vs an expense of $62 million in 4Q21. That added as much as 6 cents to EPS for 4Q.

- **Workforce rebalancing came in lower than expected at only $4 million.** Historically, this is lumpy but **can average $200-$500 million per year.** Much of it relates to integrating new acquisitions – which is an area where IBM continues to focus with 30 deals in the last 3 years. It came in at only $50 million for all of 2022 still depressed after an unusually large charge in 4Q20. We continue to expect this to be a much more sizeable and recurring charge for IBM's results going forward. **$50 million per quarter is 4.5 cents in EPS headwind.**

- **Depreciation dropped again and added $73 million y/y or 6.8 cents to EPS**

- **IBM announced this tailwind will continue in 2023 as it changed the depreciable lives** of existing server and network equipment from 4 years to 5 and new equipment from 5 years to 6. This will add $200+ million to earnings in 2023 or about 4.5-5.0 cents more per quarter.

- Share compensation fell $15 million adding almost 2 cents to 4Q22.

- Cuts in advertising added $32 million or 3.0 cents to EPS in 4Q22.

- **R&D was down in dollar terms and percentage of sales adding 2 cents to almost 5 cents.** SG&A without advertising, workforce rebalancing, amortization of intangibles, stock compensation, or bad debt was down $117 million in dollars or as much as 11 cents. We'll point those out solely to ask **why isn't IBM seeing wage inflation.**

- Bad debt expense rose $30 million for a 3.0 cent headwind

- Guidance is for about 8 cents of headwind from lower pension income in 2023 against nearly 20 cents in tailwind from lower depreciation. We think workforce rebalancing could be a wildcard that approaches another 15-20 cents in headwind the market is not expecting along with higher R&D.

- The company had a solid new Z-System roll-out. Now the comps look tougher after 1Q. The bold figures in the table below are Z-Systems growth, the non-bold figures are the full systems unit's growth rate, and Z-Systems were called as leading the full unit:

Z-System Growth	**4Q**	**3Q**	**2Q**	**1Q**
2022	**16%**	**88%**	**69%**	**-19%**
2021	**-6%**	**-33%**	**-11%**	4%
2020	-18%	-15%	**69%**	**59%**
2019	**62%**	-15%	-20%	-11%

Iron Mountain Incorporated (IRM)

Date Added	12/4/2020
Market Cap	$15.3 B
P/FFO (fwd)	19.0
Short %	5.3%
Current EQ Rating	1- (Strong Concern)

IRM's 4Q22 FFO of $0.74 was flat y/y, was down 2 cents sequentially, and missed forecasts by 1 cent. AFFO was $0.98, up 6 cents y/y and flat sequentially. We believe IRM relied on unsustainable sources of earnings, and this was actually a miss. Guidance looks poor too. 4Q results annualized would be EBITDA of $1.89 billion vs. guidance of $1.94-$1.98 billion. That's 3%-5% growth- the same as forecasted AFFO gains.

- IRM cut maintenance capital spending by $9.4 million y/y and $2.6 million sequentially. This helped AFFO by 3.2 cents and 0.9 cents.

- Ignoring principal payments on financing leases added $15.6 million, or 5.3 cents, to both FFO and AFFO.

- Adding back recurring stock compensation helped both FFO and AFFO by 3.7 cents.

- We noticed 4Q22 was the first time IRM added back derivative amortization. This $9.1 million helped FFO and AFFO by 3.1 cents. This is likely a new item related to more international exposure.

- Non-cash rent expense rose y/y by $3.9 million to $6.0 million. This is part of the inducement giveaways to steal customers. It was 2.1 cents in AFFO for 4Q22, with the y/y increase being 1.3 cents.

- Cash inducement spending in the 4Q was $18.2 million – IRM ignored 6.2 cents of cash spending in this recurring area.

- Boosting price on the records storage business also drove results. Volume was up only 0.4% with pricing up 10.6% - Every 1% of pricing adds 2.5 cents to FFO and AFFO.

- Operating lease costs rose by 7.1% y/y and we noticed that IRM is borrowing more money at 6.2% for its growth. Going forward, we expect the cost of debt to continue to increase.

- Much of the growth coming out of Covid was for services which include picking up, organizing, delivering, and destroying documents. This source of revenue has now declined for three straight quarters.

Service Growth	**4Q**	**3Q**	**2Q**	**1Q**
2022	$509.6	$526.6	$536.4	$497.0
2021	$434.4	$411.5	$401.5	$374.0
2020	$362.4	$340.4	$305.3	$385.2
2019	$404.1	$388.9	$397.6	$390.9
2018	$402.6	$404.0	$405.4	$391.3

- IRM is not immune from recession. It used to tout that volumes in storage remain very sticky and that from 2006-10, it had positive volume growth. However, we found that from 2008-10, IRM had negative volume changes of about 2% per year. Also, IRM noted that during that time, customers pulled volumes out or had more destroyed to end their storage fees. Plus, new volumes came in more slowly and the lead time to win new business grew longer. We believe that also bodes poorly for continued large price hikes in this unit.

- People own IRM for its dividend of 61.85 cents per quarter. This dividend used to grow at 5%-7% annually. It's been flat since October 2019. We have pointed out several times that the 98 cents in quarterly AFFO looks overstated as it excludes too many cash fulfillment costs and several other items noted above. We believe AFFO is inflated by 24 cents from ongoing costs being ignored. AFFO picked up 25 cents from price hikes and that full amount may not be sustainable. Plus IRM's financing costs are rising.

Keurig Dr. Pepper Inc. (KDP)

Date Added	12/4/2020
Market Cap	$50.1 B
PE (fwd)	20.0
Short %	1.2%
Current EQ Rating	2- (Weak)

KDP's 4Q22 adjusted EPS of $0.50 missed by 1 cent. This is after just meeting forecasts for the first three quarters of 2022. We see several areas helping earnings that may be difficult to maintain:

- **KDP uses finance leases** and the principal payments are rising. This does not show up as an expense and it was $25 million in 4Q22, up from $14 million y/y. This added 1.4 cents to EPS.

- **KDP's stock compensation dropped y/y from $20 million to $14 million.** It adjusted out $4 million last year and only $2 million in 4Q22 – creating a $4 million decrease or 0.2 cents in EPS. For 1Q23, investors should remember that KDP booked a $15 million credit for stock compensation in 1Q22.

- **Marketing and R&D have been lower since Covid.** They only quantify this in the annual results. On the earnings call, **management pointed to a large increase in marketing coming in 1Q23. $50 million of this type of expense is about 3 cents in EPS for KDP.** We believe the company is still $100-$150 million light.

	2022	2021	2020	2019
Advertising	$537.0	$540.0	$489.0	$670.0
R&D	$65.0	$66.0	$69.0	$81.0

- **KDP is also taking pricing in excess of FX losses in Latin America. Every 500bp is about 0.5 cents per quarter.** This has been an anomaly in our view.

Latin Am	4Q22	3Q22	2Q22	1Q22
Price	13.2%	17.3%	14.5%	9.6%
FX	-6.5%	-1.9%	0.0%	-0.8%

- **Restructuring/Integration and Productivity plans continue to be a material amount of EPS** that is added back to adjusted earnings despite it being years since the last deal. Shouldn't these get smaller?

Productivity	4Q	3Q	2Q	1Q
2022	$0.03	$0.03	$0.03	$0.03
2021	$0.03	$0.02	$0.02	$0.02
Restructuring/Integration				
2022	$0.04	$0.02	$0.01	$0.02

Integration is normally right-sizing real estate and headcount plus merging computer systems and H.R. departments. It's been going on for 4-5 years- isn't this done?

- **Falling depreciation is being offset by higher lease expense. KDP has been selling off assets in sale-leaseback transactions.** Is this really helping earnings?

Depreciation	**4Q**	**3Q**	**2Q**	**1Q**
2022	$98	$96	$99	$106
2021	$106	$98	$104	$102
Lease Expense				
2022	$72	$68	$68	$65
2021	$61	$57	$60	$54

- **A few impairments hit in 2022 – shouldn't the discount rate be rising more?** KDP has $20 billion in goodwill and $22 billion in indefinite-lived intangible assets. It recorded impairments of $311 million on the *Bai* and $166 million on the *Schweppes* brand names last year. We noticed that despite the surge in interest rates, KDP hasn't changed its discount rates very much after a steep drop in 2020:

Discount Rate	Range
2022	7.3%-10.3%
2021	6.5%-10.0%
2020	6.0%-10.0%
2019	7.3%-13.0%

- **Payables have reached 268 days now.** Suppliers have sold $3.8 billion, or 198 days of KDP's payables. There is no comment concerning the rising cost of doing this to the suppliers. Two years ago, this was essentially free at 10-15bp. Now, it is likely 5%-6%. We still believe this is debt that KDP may be forced to deal with this on short notice.

- **KDP only focuses investors on bank and bond debt less cash.** The factored payables of $3.8 billion, a structured payable (a corporate credit card) of $137 million, and the PV of finance leases of $713 million should be viewed as debt too. KDP says its debt/EBITDA ratio is only 2.8x based on $11.6 billion of net debt. We calculate debt at $16.3 billion which results in a debt/EBITDA of 4.0x. Investors should also remember that KDP spent the cash it pulled in from the factored payables and all the sale-leasebacks that are boosting lease payments. Cash is only $535 million and the dividend is $285 million per quarter.

Mohawk Industries, Inc. (MHK)

Date Added	9/27/2022
Market Cap	$5.9 B
PE (fwd)	10.5
Short %	3.2%
Current EQ Rating	2- (Weak)

4Q non-GAAP EPS of $1.32 for 4Q22 beat by 3 cp,. However, on January 16 (after the close of the quarter), the company lowered its 4Q guidance from a range of $1.40-$1.50 to $1.27-$1.31.

We found it interesting that MHK's 4Q adjusted effective tax rate was 12.6% which was down from 17.9% in the third quarter and 18.9% a year ago. In the third-quarter conference call, management forecasted a 20% tax rate for the fourth quarter. There was no update to the tax rate outlook in the January 16 revision press release and we saw no public mention of any reduction to the tax rate outlook. It appears to us that analysts were not expecting the fourth-quarter rate to be nearly that low. The lower-than-forecast rate added 11 cps to EPS.

- **Trade receivables DSOs rose to 55.8 versus 53.7 in the year-ago period**. Management noted in the call that this was "due in part to customer and channel mix." We also note that "other receivables" rose to 7.5 days of sales from 3.8 days in the year-ago quarter. This should have helps sales and EPS.

- **The warranty accrual as a percentage of revenue rose sequentially from 1.3% to 1.4% but remains well below normal levels.** We estimate that it would cost 6 cps to increase the reserve percentage to the year-ago level, but it would take 18 cps to increase the reserve percentage to its pre-Covid level of 2%.

- **Inventory DSIs rose to 123.7 from 106.6 in the previous year.** Management made inventory reduction a priority in the fourth quarter due to moderating demand and the expectation that costs will begin to ease in the first half of 2023. It limited production in the fourth quarter, which decreased fixed cost absorption and pressured margins. The high-cost inventories are expected to work their way through the income statement in the first quarter which will continue to pressure profitability. Management hopes to rebuild inventory at a lower cost as the year moves on.

- **Lower stock compensation expense added 1.6 cps to EPS.**

- **The allowance for discounts, claims, and doubtful accounts as a percentage of gross receivables rose to 4.3% from 3.8% in the previous quarter.** We have highlighted in recent reviews how the company has been reducing its receivables allowance since it was raised during Covid but that the level has fallen below the pre-Covid norm. The company doesn't provide provision expense, but we estimate the sequential increase in the reserve percentage was an 11 cps headwind to EPS. We are less concerned about this item moving forward other than the possibility that a slowing economy could lead to the company having to continue increasing reserves which is not a company-specific problem.

- MHK **announced it settled its shareholder lawsuit related to the alleged manipulation of receivables and inventory balances for $60 million.** It continues to state that the case is without merit and it is settling to avoid the distraction. However, the related US Attorney and SEC investigations into the matter are still ongoing. Our stance has been that while inventories were definitely inflated, the company was somewhat forthcoming at the time that it was carrying excess inventory which it later worked down. If the allegations of excessive levels of unusable inventory on hand were true, it would have likely required a sizeable write-down to resolve which never occurred.

Post Holdings, Inc. (POST)

Date Added	3/30/2022
Market Cap	$5.3 B
PE (fwd)	23.7
Short %	4.1%
Current EQ Rating	3- (Minor Concern)

POST reported 1Q23 (December) adjusted EPS of $1.08, which beat by 46 cents. Guidance rose for EBITDA from $990-$1040 million to $1025-$1065 million. We are not impressed. EBITDA came in below 4Q levels at $269.9 million and POST's guidance is below the annualized level of 1Q too. We do not believe the beat is sustainable.

- **POST picked up 3.3 cents from cutting advertising again**. Competitors are raising their spending.

- **Costs it expects to be indemnified for appeared again.** This was not an item that appeared in POST's results until 3Q22. It added 1.4 cents to EPS.

- **Depreciation & Amortization dropped $3.8 million, adding 4.4 cents to EPS.**

- **The biggest driver of EPS and EBITDA was POST taking pricing gains that far exceeded inflation on costs**. Pricing rose $231.2 million, raw material costs rose $142.7 million and manufacturing costs rose $14.4 million – netting POST $74.1 million for the quarter or 85 cents in EPS.

- **Egg prices have dropped considerably in January and February.** Looking at the *Trading Economics* website, we see after holiday baking eggs dropped from $5.35/dozen to $2.20. Easter baking and Easter eggs traditionally drive up egg prices in March and already have, but prices are still more than $2 lower than December. Much of the egg-laying hen population has been restored and those hens are maturing now which boosts production more. We doubt POST will keep its pricing based on $5 eggs for long.

- **A dramatic drop in freight costs which POST called out as $108.6 million for all of fiscal 2022, were only $19.5 million in 4Q22 and were not called out at all for 1Q23.** This could be 15-20 cents too.

- **Inventory levels still look too low at 47.6 days vs. normal levels above 50.** Another issue here may be that finished products are up, but in the discussion of earnings, POST said it is seeing a shift to lower-margin private label sales.

- **POST is buying some pet food brands from J.M. Smucker (SJM) for $1.2 billion.** That includes $500 million in POST stock along with $700 million in cash. We are not thrilled by this deal on first review and see another low ROI project for POST of about 5.3%. We believe POST may have to borrow money at rates greater than that ROI. Plus, SJM saw pet food volumes jump during Covid like several other companies. It has now seen volumes turn negative and there SJM took several impairments against those assets.

Sealed Air Corporation (SEE)

Date Added	12/4/2020
Market Cap	$6.8 B
PE (fwd)	12.8
Short %	1.5%
Current EQ Rating	2+ (Weak)

SEE cut guidance after the 4Q22 was complete, but before results were announced so it could claim it beat forecasts. We're not so sure about that- after 3Q22, guidance for 4Q22 was $0.94-$1.04 (vs. $1.12 in 4Q21). On January 17, it cut guidance to $0.89-$1.04 – then claimed its $0.99 beat by 1 cent. This is a recurring event for SEE we see it happening in current guidance too:

- **Guidance for 2023 looks weaker at first glance.** Removing the Liquibox deal from the forecast, organic growth could be negative to 0% for a company touting its high-demand products and its higher pricing already in place continuing. EBITDA would be down to basically flat even with the multi-year restructuring continuing. Plus there are likely some of the $30 million of expected synergies from Liquibox added in too.

- **Is the depreciation/amortization forecast of $275 million in 2023 an easy way for SEE to "beat" guidance?** Falling depreciation and amortization in 4Q gave SEE 1.5 cents toward its 1-cent beat. Now it sees it rising from $185 million to $275 million. It blames higher capital spending in recent years, but that does not begin to explain the $90 million forecasted jump. We don't know the allocation for the Liquibox deal yet, but it seems likely much of that will go into goodwill and not be expensed. To get to $90 million, we needed an average life of acquired PP&E and intangibles of about 4 years. But, SEE uses average lives of at least twice that period for most similar assets.

- **We think investors should watch for pressure on pricing and margins from high inventories too. DSIs are normally 60 days in 4Q and 70 days in other quarters. SEE is 20 days higher than those norms.** It also uses FIFO accounting and the raw material prices are going down now. They could find themselves selling inventory acquired at higher costs at lower prices going forward.

- **We question if SEE can keep all its pricing.** Management is pointing to weakness on volumes as its customers are destocking. Volume losses exceeded pricing gains in 4Q EBITDA. Raw material cost inflation/deflation is supposed to pass through to customers and net to $0 over time. We think SEE may be $200 million ahead of the curve there and historically this is something where they get ahead or behind by $20-$30 million. The 4Q saw the weakest gain in this area by a wide margin compared to the rest of 2022.

- Pricing has also benefitted by taking large increases to offset FX losses in Latin America. That is losing steam too. SEE was getting quarterly $169 million hikes in the Americas region early in 2022 against almost no FX hit. In 4Q, this region only booked $54 million in pricing against $11 million of FX losses.

- Looking at 4Q22's beat further – SEE picked up 7 cents from a number short-lived items – some of which it likely knew before it cut guidance in January.

    - Guidance for 2022 after 3Q expected 148 million shares. Share count was 147.4 million – which added 1.2 cents to 4Q22 EPS.

    - Guidance after 3Q22 was for a 25.5% tax rate, which came in 10bp lower than that – which added another 0.5 cents.

    - Operating costs had been a headwind all year until 4Q, when they added $10 million to EBITDA – that was worth 5 cents in EPS.

    - Depreciation/Amortization was up all year, but suddenly fell $2.9 million in 4Q adding 1.5 cents to EPS.

    - Share-compensation and profit sharing fell by $1.3 million adding 0.7 cents to 4Q22 EPS.

    - Adding back 3rd party consultant fees was another 0.5 cents.

    - Inventory obsolescence jumped to $6.4 million in 4Q, and y/y by $4.8 million which cost SEE 2.4 cents.

On Deck Risks

Becton, Dickinson and Company (BDX)

BDX's non-GAAP EPS of $2.98 for its 1Q22 ending in December beat by 30 cents. We believe several areas drove this beat in an unsustainable manner:

- After guiding to an effective tax rate of 13.5%-14.5%, BDX came in at only 6.2% for the quarter. That sizable difference was worth 25 cents in EPS.

- Receivables rose 3.5 days sequentially and 9.1 days y/y. There was no explanation for this. We did see a reference to respiratory sales "benefitted from the timing of orders." BDX is also factoring more receivables now to boost cash flow. But, we are seeing the cost of such programs rising rapidly for many companies.

- The company paid down $500 million in debt in the quarter and cited its net leverage ratio as being 3x. However, we estimate that after factoring in its $2 billion in legal accruals the leverage ratio rises to 3.6.

- Inventory DSIs are far above pre-Covid levels and rose 29 days sequentially. Higher costs are building into inventory, which should continue to pressure margins. BDX noted on the call that inventory already improved in January. We will look for signs of that this quarter.

- Prepaid expenses have been rising for a full year now. This may include increased capitalization of expenses to help earnings. This is up $500 million y/y now. If this indeed involves capitalization which defers expenses – every $100 million deferred is 28 cents in EPS.

Cintas Corp (CTAS)

CTAS reported EPS of $3.12 in the second fiscal quarter ended November beating estimates by 9 cps. Management raised guidance for the full year ending March from a range of $12.30-$12.65 to a range of $12.50-$12.80, or 15 cps on the top end, signaling that it expects some of the momentum to carry forward. However, we saw more signs of unsustainable benefits in the quarter:

- **The unusually high reserve for obsolete inventory fell again by almost $20 million despite an increase in inventory.** This reserve was built up to reflect the falling value of PPE products from COVID. It remained elevated until it started to decline in the August quarter. A $20 million sequential decline in the reserve could have added 15 cps to profits in the quarter. The inventory reserve is still about 12% of gross inventory versus the high 8% range pre-COVID, so there is still some room left to benefit from further cuts to the reserve.

- **The "other assets" account increased in the last three quarters.** We suspect this relates to amounts paid to customers at the beginning of contract periods which amortizes over time. The account jumped by over $50 million in the 5/22 quarter and then by $10 million in the 11/22 quarter which could be an indication of an increased rate of capitalizing these amounts. A $10 million increase amounts to 7 cps.

- **Gross margin rose 100 bps in the 11/22 quarter. This was driven by expansion in the First Aid and Safety Services segment which accounts for only 11% of sales.** It also was aided by Covid PPE sales becoming smaller. Both trends should be tough to continue, and margins are now 200bp above pre-Covid levels.

- While the tax rate of 22.1% was higher than the 18.0% rate last year, the company issued guidance for a full-year rate of "over 20%" after the first quarter ended in August in which it recorded an effective tax rate of only 15%. Therefore, we doubt November's 22% was meaningfully above what analysts were expecting.

Medtronic plc (MDT)

MDT beat forecasts by 3 cents in 4Q22. The whole beat came from a rise in non-GAAP operating income which was 4.3 cents, almost entirely coming from interest income. Normally, MDT earnings quality is high relative to many of its industries. However, we see a few issues that may negatively impact EPS in the near term:

- **Other accrued expenses dropped $400 million last quarter**. Every $100 million is worth 6 cents in EPS. The accruals had risen in 2Q and 3Q, but the increase was not $400 million before last quarter's drop. Management explanations do not fully account for this.

- **MDT beat forecasts on revenues, but this is now two quarters in a row of receivable DSOs increasing.** DSO's at 69.3 days are near the high-end of normal levels. We're more concerned that MDT blamed "timing of sales, slower collections, and supply change challenges."

- **Inventory DSI levels of 185.9 remain 26-36 days higher than normal**. Management blames inflation for driving up inventory levels and working that off could negatively impact margins. We also think DSIs should be showing some more meaningful rates of decline after only falling 1.4 days last quarter.

- **MDT lost a $106 million patent infringement case that is now under appeal.** No reserve has been set up for the loss so there is a potential 6-cent hit to EPS that could appear if the appeal is denied.

Teva Pharmaceuticals (TEVA)

We typically move TEVA to a Focus Risk from On-Deck whenever the stock price is above $11. This happens on occasions when the market feels positive about various legal issues surrounding TEVA. 4Q22 adjusted EPS of $0.71 hit guidance. Plus 2023 guidance if for flat EPS. We see many reasons to view 4Q earnings as poor:

- New sales allowances exceeded the amount used by $102 million – which was an 8-cent headwind. We have noted in the past that this has frequently been a 25-35 cent driver for EPS. It has also been $0.5-$1.0 billion of EBITDA. This long decline in allowances is no longer a given for TEVA's earnings.

- TEVA has been cutting marketing, advertising, and R&D spending. Sales and marketing cuts in dollar terms and as a percentage of sales added 4-7 cents to EPS. Cuts to R&D in dollar terms and percentage of sales added 2-3 cents to EPS.

- Teva added back accelerated depreciation which added 3 cents to EPS.

- The company lives in court and considers that a part of its operating model. However, it adds back lawsuit expenses – which was 2 cents of adjusted EPS.

- A mysterious jump in "other non-GAAP" items added back that included other accelerated depreciation and inventory write-offs of $98 million added 7 cents.

- Debt is not declining as much as management claims. First, it ignores the litigation accruals, which are now $4.2 billion up y/y from $2.7 billion. Also, it nets debt against cash on hand, which rose y/y by $636 million – but they ignore that TEVA started selling US receivables which added $820 million to cash.

- Impairments continue too. TEVA still has almost $24 billion in goodwill and intangibles on the books. It took write-offs of $2.4 billion last year. The impairment test occurs in 2Q and rates have risen considerably since 2Q22. TEVA noted that only a 50bp in discount rates would reduce the cushion on intangibles to only 5%.

Top Values

Air Lease Corporation (AL)

Date Added	9/27/2022
Market Cap	$4.3 B
PE (fwd)	7.6
Short %	1.8%
Current EQ Rating	4+ (Acceptable)

We see this as a book value and interest spread story and in both cases, the story remains compelling in our view with conservative accounting clouding some of that. We believe AL could be sold today at a 40%-50% premium to the current stock price. The rate of new planes arriving is starting to improve and that should lead to higher revenues and help income recover as well.

- Book Value is $52 vs. share price of $38-$39. We see $5.50 in additional book value from insurance claims on nationalized Russian aircraft. Deferred rent payments from Covid still outstanding is another $1. Used plane values are rising due to a lack of new aircraft for several years. AL is realizing gains on aircraft sales. Both situations indicate that the value of aircraft may be higher than the depreciated value on the balance sheet. Every 1% positive change in net value is worth over $2 in book value.

- Interest spread also remains compelling and helps L-T Growth. AL uses largely fixed-rate borrowing to lock in a spread on leases for 7-10 years on average. There is a 300bp spread between its cost of capital and its customers. On top of that, AL gets the tax shield from depreciation and interest expense. When it sells the plane, it often books a gain too.

- At this time, AL's fixed cost of borrowing is over 200bp below the market, giving it a 500bp spread. Only about 12%-15% of the debt rolls annually. Plus, lease contracts have escalation clauses that rise until the plane is delivered and locked in, so the spread for planes on order is currently rising. This should also boost the size of the leasing market as customers need cheaper capital, which can grow AL's asset base with more sale-leaseback deals.

- The outlook looks stronger with $4-$5 billion in new plane deliveries vs. $3.6 million in 2022 and $1-2 billion in aircraft sales vs. just over $200 million in 2022.

- 4Q22 EPS missed by 3 cents: Earnings were pressured by $4.7 cents from higher insurance premiums. It still has about 5 cents in rent it will book when cash arrives and that is a lag. More deferred rent arrived, but it's a smaller item than in 2021 which was a 3.6-cent headwind, and AL capitalized less interest for another 0.4 cent headwind.

- EPS was helped by the repurchase of over 3 million shares – adding 4 cents to EPS and a new preferred stock issuance hurt that by 0.9 cents.

Air Products (APD)

Date Added	4/10/2023
Market Cap	$62.6 B
PE (fwd)	24.8
Short %	0.95%
Current EQ Rating	4- (Acceptable)

APD's 1Q23's $2.64 in adjusted EPS missed forecasts by 6 cents despite a few unusual factors that helped EPS. The market seemed more upset over guidance of $2.50-$2.70 for 2Q23, changes in the structure of a key project, and rising interest rates. We believe the market is overreacting and the long-term growth story remains intact.

- We believe concerns over the change in the NEOM plant deal are overdone. While the Street is focusing on the increase in upfront costs, we believe the change in structure will result in higher ROI for APD's investment. It also frees up cash for other projects.

- APD announced coming into the year it was going to adjust out non-service pension costs – largely actuarial charges due to rising interest rates from EPS. That added 7 cents to non-GAAP EPS but was well-known going into the quarter. However, APD now excludes the interest cost in pension expense and only focuses on service cost. Adjusted pension expense actually fell y/y from $11 million to $6.3 million despite higher interest rates. This added 1.7 cents to non-GAAP EPS.

- Taxes were a 7-cent headwind rising to 19.1% from 17.0%. However, APD guided to 19%-20% so this was likely a small benefit versus analysts' models.

- Depreciation and amortization declined y/y and sequentially, adding 4 cents to EPS. With PP&E up and all the projects coming online, this seems unlikely to last.

- Equity affiliate income was down 14 cents on the surface, but actually up 6 cents adjusting for the 20-cent one-time benefit in 1Q22 from recognizing deferred profits on the Jazan project.

- FX was a sizable negative of 15 cents in the quarter. After being a positive for EPS in 2021, it became a sizeable headwind in 2H22 through now:

- Guidance of $2.50-$2.70 for 2Q23 is tied to how rapidly Chinese business picks up. APD noted a weaker-than-expected China and Europe for 1Q. However, it is seeing power prices in Europe stabilize and it has price increases in place. We would expect depreciation to rise and FX to remain a headwind.

AT&T, Inc. (T)

Date Added	3/12/2021
Market Cap	$140.1 B
PE (fwd)	8.0
Short %	1.2%
Current EQ Rating	4+ (Acceptable)

We see T’s earnings growth continuing with better cash flow and a stronger balance sheet. Several cost savings measures continue to yield results and economies of scale in broadband should improve.

- New broadband roll-out has gone faster than original plans. Capital spending is expected to come in flat with 2022’s $24.3 billion which includes $4.7 million in vendor financing payments. In 2023, the $24 billion should also include at least $4.6 billion in vendor payments. Capital spending should remain about $20-$21 billion in 2024, which will still allow for growth, but boost free cash flow by $3-$4b. Government funding for broadband investments is also expected to start helping cash flow in 2024.

- Free cash flow was penalized in 2022 by about $1.85 billion and FCF was $14.1 billion. Half of that was due to higher deferred acquisition costs of new customers that T expects to level off. They expect lower deferrals in 2023 and will release about $2 billion from working capital. Even with higher taxes and less of a payment from DirecTV, FCF is expected to come in above $16 billion. That provides 2:1 coverage for the dividend.

- AT&T is retiring its mobility preferred stock. This started as $8 billion and $2.6 billion was retired for cash in 4Q22. AT&T will retire $2.67 billion in 4Q23 and 4Q24. This is important because it saves cash on the dividend – about $185 million each year up to $560 million. Also, as they settle the preferred shares with cash, the diluted share count will drop by 378 million or about 5%.

- Debt is expected to decline to 2.5x EBITDA by early 2025. Currently, it is $132.2 billion in debt over $41.5 billion in EBITDA, or 3.2x. AT&T plans to retire debt in 2023 and 2024 with FCF over the $8 billion dividend. That implies a reduction of $5-6 billion in 2023 as it retires preferred stock and $9-10 billion in 2024, with another $4-5 billion in early 2025. That would reduce debt by just over $20 billion and every $7 billion transfers $1 in enterprise value from debt to the stock price or basically $3 vs. the current $19. Also, $8 billion in preferred stock transfers. It implies an EBITDA growing to only $45 billion from 2022’s $41.5 billion and no multiple expansion. The company is trading for 6.7x EBITDA.

7x on the $45 billion without preferred stock and lower debt – is a $28.50 stock price, 8x is $35.

- Cost savings for AT&T is still expected to reach the $6 billion run rate by the end of 2023. It finished 2024 at a run rate of $5 billion. We believe, it likely has about $2.0-2.5 billion more to be realized as this annualizes.

- Another source of hidden operating leverage here is adding incremental users to the new broadband. The initial adds require more spending but ROI jumps and costs fall as the same infrastructure draws more users. The same should be true of switching more business wireline to mobility and fiber infrastructure.

- Price increases continue for both wireless and broadband. AT&T boosted prices a bit in mid-2022, some of that has not annualized yet.

- AT&T called out headwinds for 2023 EPS of 25 cents. This includes 5 cents from a higher tax rate, 20 cents from higher interest rates on pension expense, plus less capitalized interest on spectrum as it will be in use. Much of this is non-cash and AT&T's guide is for 1%-6% EPS growth adjusting for the pension and taxes.

Costco Wholesale Corporation (COST)

Date Added	12/2/2022
Market Cap	$215.5 B
PE (fwd)	33.6
Short %	0.80%
Current EQ Rating	5+ (Strong)

Costco does not have much in the way of earnings quality issues that concern us. There are a few moving parts such as LIFO charges and gasoline prices impacting sales and margins to be aware of, but in the big picture, COST is about as clean as it gets. The company does not use non-GAAP EPS. Thus, some of the accounting procedures can be positive or negative in any given quarter and COST is very upfront in pointing this out and quantifying it. For 2Q23, EPS of $3.30 beat by 10 cents and was up from $2.92 y/y.

- LIFO charges were $0 vs. $71 million the prior year as costs are now coming down. That was worth 12 cents in EPS. COST noted it's not just commodity prices but shipping costs are falling and the time to get product is shrinking. For 3Q and 4Q it may have a $0 LIFO charge vs. $130 million and $223 million which drives earnings further.

- Lower costs are helping cash flow and pushing up cash balances. Interest income jumped $89 million y/y – adding 15 cents. This tailwind should continue.

- COST is seeing higher comp sales for food, better sales of its private label products, and general grocery items. Comp sales overall remain positive against tough comps, which remain tough:

Comps	Mar 23	Mar 22	Mar 21	Feb 23	Feb 22	Feb 21	Jan 23	Jan 22	Jan 21
US no FX	0.9%	12.7%	11.3%	3.5%	12.9%	10.3%	6.9%	9.5%	16.4%
full Co. no FX	2.6%	12.2%	11.1%	5.0%	10.6%	12.3%	7.4%	10.8%	15.7%

- What is weak are big-ticket items like electronics, jewelry, hardware, housewares… Those comps have turned negative after being very high in 2021 and 2022. Management notes those are only 8% of total warehouse sales but they carry higher sales prices per unit.

- Gross profit in dollar terms still grew 26% y/y on 6% merchandise sales growth. That's with COST reducing prices where it can. Higher sales and more members are still offsetting the bulk through wage increases COST has given in the last year. SG&A was up only 13bp – or a $70 million headwind – offsetting the 12 cents from LIFO.

- COST has not raised the membership price but has seen more members and more existing ones upgrade to the higher levels. If they boosted the price by $1-$5 per year it would add $0.20-$1.00 to EPS.

Docusign (DOCU)

Date Added	4/10/2023
Market Cap	$11.4 B
PE (fwd)	23.4
Short %	5.2%
Current EQ Rating	4- (Accepteble)

DOCU posted a positive GAAP EPS of 2 cents last quarter. Adjusted EPS of $0.65 in 4Q23 beat estimates by 13 cents. There remain negatives and positives as this company continues its transition to a more trained sales force, more product innovation, and greater adoption of products throughout customer organizations.

- Adjusted Operating Margin came in at 23.6% vs. forecasts of 20-22%. The recent restructuring to reduce headcount played a big role there. Given that 3Q23 results were also a 23.6% margin, we think guidance was too low. The 160bp over guidance was worth 4 cents in EPS.

- Subscriber Revenue beat handily by $15.7 million. That added 1.5 cents to EPS. Again, for a company that gives revenue guidance with a very narrow $4 million band, beating the high-end is a positive in our view.

- Professional Services went back to a sizeable loss again. This was a large headwind for earnings. This service is for clients that want help setting up DOCU software and training. In 3Q23's EPS of 57 cents, this was a positive swing of 2.5 cents in EPS and 100bp of operating margin. Now on the 4Q23's 65 cents, it cost DOCU 3.5 cents in EPS and 130bp of margin:

	1/23/2023	10/22/2023	7/22/2023	4/22/2023	1/22/2023	10/21/2023	7/21/2023	4/21/2023
Professional Sales	$15.9	$21.4	$17.0	$19.4	$16.8	$16.9	$19.1	$17.1
non-GAAP Pro Income	-$8.9	$1.6	-$5.0	-$2.5	-$9.6	-$6.3	-$2.6	-$3.2

- Stock compensation as a percentage of sales rose in 4Q. This removed more cost from the adjusted earnings. We consider this a negative as the ratio should be 20% vs. the 22.4% it just posted which added 2.8 cents to EPS.

	1/23/2023	10/22/2023	7/22/2023	4/22/2023	1/22/2023	10/21/2023	7/21/2023	4/21/2023
Sales	$659.6	$645.5	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1
Stock Comp	$145.9	$135.2	$141.2	$110.7	$118.0	$109.4	$100.0	$81.1
Taxes on Exercise	$1.9	$2.5	$3.4	$5.1	$4.2	$10.1	$11.6	$16.3
Total	$147.9	$137.7	$144.6	$115.8	$122.2	$119.5	$111.5	$97.4
% of Sales	22.4%	21.3%	23.2%	19.7%	21.0%	21.9%	21.8%	20.8%
Stock Comp %	22.1%	20.9%	22.7%	18.8%	20.3%	20.1%	19.5%	17.3%

On earnings overall – we consider the beat real. A 13-cent beat with the professional sales loss of 3.5 cents more than offsets the earnings gains from a low forecasted margin and seeing the stock compensation percentage increase.

The market was strongly disappointed in guidance for billings coming in at 2% for 1Q24 and even forecasting a back-loaded year with billings at only up 2.5% for fiscal 2024. For a software company, that's a serious red flag. Billings become future revenues so slower billings should mean slower revenue gains.

- Billings and near-term revenue is still being hurt by real estate-related transactions that were early adopters of DOCU software. Fewer people are buying/selling/refinancing homes right now.

- DOCU is making forecasts off what it is currently seeing in results, not trying to predict what could change – so the billing forecast is likely very conservative.

- What caught our eye is some of the key metrics turned up in the last quarter:

	1/23/2023	10/22/2023	7/22/2023	4/22/2023	1/22/2023	10/21/2023	7/21/2023	4/21/2023
Rentention	107%	108%	110%	114%	119%	121%	124%	125%
Billings/Revenue	112%	102%	104%	104%	115%	104%	116%	112%
Deferred Rev DSOs	166	157	162	162	166	162	169	163

  - Retention still declined but is still above 100% and the rate of decline slowed. As that measures dollars spent by the same clients y/y, it is still getting growth from the existing base.

- Billings/Revenue fell to 102%-104% since DOCU began reorganizing and training its sales force – It just returned to 112%. There are signs in the earnings slides which indicate that larger customers are buying more.

- Deferred revenue (contract liabilities) had been slipping for several quarters. That is what becomes future revenue and it bounced up 9 days in 4Q23.

DOCU also announced it would reduce headcount by another 10% and will reinvest some of that savings into more R&D and tie-ins with other software services. That cut will happen largely in 1Q24 (April) and even reinvesting some savings in R&D, the adjusted operating margin forecast of 21%-23% for fiscal 2024 looks low to us. They are already above the high end of that range now before the 10% cut in the workforce. It sounds like the newly-trained sales force is ready to give demonstrations, training, and installations of the software. That could enable DOCU to cut the loss in professional sales – and that alone was a 130bp negative swing in margin in 4Q23.

LyondellBasell Industries N.V. (LYB)

Date Added	7/14/2021
Market Cap	$30.7 B
PE (fwd)	10.5
Short %	3.0%
Current EQ Rating	5+ (Strong)

Mid-cycle EBITDA is still expected to be $9 billion on better cost savings progress. At $93/share – LYB is trading for 4.4x EBITDA. Debt is 1x EBITDA and it should generate free cash flow > $4 billion. The rising dividend is only $1.5 billion representing a 5.1% yield. That leaves plenty of cash flow to repurchase shares, fund growth, or pay special dividends – all which LYB has done. 2023 will be a year with some pluses and minuses on output.

- 2023 is expected to be a heavy year for plant maintenance. That should restrain some production longer than normal. LYB is forecasting it will lose about $290 million from major maintenance programs this year. However, with the completion of the new PO/TBA plant, total capital spending should decline by $300 million vs. 2022 to $1.6 billion with $1.1 million going to maintenance and $0.5 million to growth projects.

- Inventory DSI reached 47 days. That's up from 43 after 3Q, but still below a normal level of about 55 days. The lower production rate likely helped raise the DSI figure and 43-44 days is probably still a realistic way to view where inventory stands. That likely still means that LYB could see some cash flow headwind from rebuilding inventories by $700 million to $1 billion. Working capital freed up over $500 million in cash during 4Q, which could reverse.

- The refinery is still expected to close by the end of 2023. It may see reductions in production throughout 2023 or it may be heavily weighted to 4Q – management has not confirmed a timing schedule. However, it still sees the cost of maintaining the refinery as too high to justify keeping it open. In 4Q22, refining was $249 million of the $865 million in EBITDA. In 2022, refining was $921 million of the $6.5 billion in EBITDA.

- Offsetting the refinery going forward, LYB sees more normalization of trade flows, which allows its cost-advantaged feedstock production to shine more via exports. That should help especially amid higher oil prices. Feed costs have also improved in Europe during the 1Q23.

- 4Q22 EPS of $1.29 beat by 2 cents in an overall weak quarter with maintenance and several plants particularly in Europe operating below capacity. LYB added back exit costs for the refinery which were known and had Lower of Cost or Market hits on some inventory for $90 million in 4Q. That will likely not recur given higher oil prices in 1Q.

- LYB is still calling out that it plans to pull $750 million in costs out of operations by 2025 – that becomes a reasonable tailwind of $1.50-$2.00 in EPS growth.

Philip Morris International Inc. (PM)

Date Added	4/10/2023
Market Cap	$153.7 B
PE (fwd)	15.6
Short %	0.62%
Current EQ Rating	4+ (Acceptable)

PM has considerable US-dollar-based debt and a $9 billion US-dollar dividend. Its $10 billion in free cash flow comes from non-dollar sales. PM continually hedges, forward sells currency, and makes internal loans among subsidiaries to bring in dollars. We really like the two latest deals to drive growth and start bringing PM some US-based sales and cash flow:

- Swedish Match brings some non-smoking products, US sales and some US distribution. Buying out Altria (MO) from the heated tobacco/IQOS deal in the US market (plans to begin in 2024) could make a roll-out quicker for PM.

- Working with MO, PM would have had access to an established distribution network. However, MO had little incentive to roll out heated tobacco very quickly. PM's experience shows heated tobacco creates strong cannibalization of traditional cigarettes. That put MO in the position of losing 100% of the profits from selling cigarettes to collect half the profit from heated tobacco.

- The prior roll-out was being done very slowly with MO. We believe PM has the huge benefits of not having to defend a traditional cigarette market in the US and it should be the first product to market. Every cigarette sale that heated tobacco cannibalizes is 100% incremental profit to PM. PM sees the size of the US market at $20 billion in profits and believes it can take 10% of that within 6 years.

- This does not eliminate the currency issues for PM, but it could mitigate them. We believe PM has spent 10-20 cents on hedging and other currency issues of its $6 in adjusted EPS.

- Swedish Match accounting is aggressive as only $2.4 billion of $17.8 billion in intangibles will be expensed and PM changed its definition of adjusted earnings to add back even that small amount of amortization.

- Heated Tobacco still requires getting legal approval to roll out, and PM intends to start the necessary process in 2H23. It believes setting up US manufacturing for IQOS devices plus a different design gets past the import issues regarding the patents of the prior roll-out in 2021. It will also need to build the infrastructure to roll out the product in 2024.

- Russia is 7% of sales and Ukraine 1%. This is a wildcard if Western governments force more divestment or penalties for doing business in Russia.

Starwood Property Trust, Inc. (STWD)

Date Added	2/8/2022
Market Cap	$5.3 B
PE (fwd)	8.3
Short %	4.58%
Current EQ Rating	5+ (Strong)

4Q22 distributable earnings (DE) of 50 cents met forecasts. In 3Q22, DE of 51 cents missed by 1 cent. We believe risk focus impacted both periods:

- Real Estate Owned where STWD has taken ownership to repurpose or sell, is not earning cash income. In 4Q, this was 5 cents of headwind, and in 3Q it was 2 cents. STWD has never taken a loss on this type of project and it has agreed to sell one property coming into 2023. Cash on hand is also higher than normal and that is a drag on income.

- STWD exited its ownership in a residential mortgage originator. That resulted in an $11 million recognized loss for 4Q up from $5 million in 3Q. This was 3.4 cents of headwind for 4Q22 and 1.6 cents for 3Q22.

- GAAP diluted share count of 317.6 million includes 9.6 million shares related to convertible debt. STWD intends to repay that $250 million in debt in April and the dilution impact should vanish from the GAAP share count.

- The stock is below book value of $21.70 and can cover the 11% dividend without doing anything with the portfolio. There remain many tailwinds for earnings as STWD puts more money to work after recent volatility. These include:

- 99% floating-rate securities in commercial lending – every 50bp of interest rate increases DE by 1.5 cents. The commercial lending is lending at 60 cents on the dollar and has little if any exposure to weak areas such as NYC and San Francisco. In fact, STWD has one of the lowest exposures to US office space of its peers and is more invested in multi-family.

- 88% of its borrowing does not have triggers based on collateral values changing with market spreads. Its securitizations and CLOs do not require marks to book value. It has the ability to reload those CLOs with new loans as prior loans repay. Thus, it will be able to put higher interest rate loans into the structure and the funding costs remain 150bp below the market. Thus, STWD will see a widening cash spread there.

- In 3Q, they saw 100% of the rates on their loans exceed the interest rate floors they have in place and had higher income as a result. Going forward, 100bp of interest rate increases adds 3.3 cents to Distributable Earnings per quarter. New loans are being set up with higher floors now that would preserve higher income levels should rates decline again.

- Rent increases should continue on its property. It had a 10.6% rent increase beginning on the Florida housing properties on October 1. The rising cash flow stream is financed on fixed-cost debt too so that cash spread is widening. It should also continue to boost property values that would drive GAAP earnings and create the potential for higher dividends.

- LNR, the special servicing unit, is seeing business grow and it is being named as a servicer for more deals. This is lumpy income, but it is now special servicer on $107 billion in deals, up from $95 billion at the start of the year. It is actively working on $4.1 billion in loans and $1.8 billion in real estate in default. It gets paid at the end of work-outs.

Texas Instruments Incorporated (TXN)

Date Added	3/12/2022
Market Cap	$161.4 B
PE (fwd)	23.2
Short %	1.94%
Current EQ Rating	5+ (Strong)

TXN has a smaller exposure to consumer markets than many of its peers. It has a larger exposure to industrial areas that should see more growth in our view. It has several new plants coming online within the next three years that should lower its unit production costs. We always like that TXN has very limited non-GAAP adjustments and have only seen them related to start-up procedures for new plants before they are in production. TXN also continues to invest in the business for R&D and marketing support. It is largely run based on having a fixed cost structure that new plants should reduce and having revenue be the wildcard. It also focuses on having higher sales by avoiding out-of-stock situations as it is able to carry more inventory than many peers. It views the incremental sale vs. the cost of carrying inventory with a long shelf life as a profitable way to boost earnings. TXN's adjusted EPS of $2.19 beat forecasts by 16 cents. Some areas caught our eye for earnings quality.

- The restructuring charges relate to start-up costs of the new LFAB that went into production in December. At that time, those assets started to depreciate, and the start-up costs would also move to Cost of Goods. In the 4Q, the restructuring fell from $77 million in 3Q to $48 million – that makes sense with the plant going online. However, Depreciation was flat at $249 million from 3Q to 4Q.

- Cost of Goods fell sequentially too with lower sales. However, the drop was only $21 million on a $571 drop in sales. The drop in margin was 320bp. TXN attributed this to LFAB moving to Cost of Goods, and higher recent capital spending – which has been going up: $597 million in 2Q to $798 million in 3Q to $967 million in 4Q. OK – then shouldn't depreciation be rising now? TXN is guiding to higher depreciation as new plants come online. They believe it will rise from $1 billion in 2022 to $2.5 billion with annual increases of $0.5 billion. They will need sales growth to turn up to leverage that type of cost increase.

- TXN noted it picked up 11 cents in EPS that was not in guidance. This looks like it came from taxes. Guidance was for a 14% tax rate for the year. Through September, the tax rate was running at 14%. In 4Q, it came in at 9.5% and was enough to take the full-year rate under 13%.

- Stock compensation rose y/y in the 4Q from $50 million to $62 million. However, that was the smallest bump all year. The other quarters were gains of $13 million, $16 million, and $18 million.

- Other income is a lumpy line item. It includes royalty income, interest income, and gains/losses on investments. Higher interest rates on cash likely account for the y/y jump of $42 million but there is no discussion on this yet. It added 4 cents to EPS.

- DSOs have now reached normal levels. There was a back-loaded quarter in 2Q with late fulfillment in China. DSO's have dropped from 38 back to the normal 33.

- DSIs had a large jump in 4Q from 136 to 160. That is by design as TXN wants to keep levels high because obsolescence is a low risk for many products and it avoids missing sales due to out-of-stock situations. It also lets TXN continue to spread high fixed costs over more output units when it continues to produce more inventory than it can sell. Even when inventory was about 120 days, TXN said it did not mind carrying 190 days. This is worth watching as they are predicting lower sales for 1Q23 and noted that customers are drawing down their inventories. On the positive side, TXN believes China reopening could cause demand to increase as 2023 moves forward.

United Rentals, Inc. (URI)

Date Added	12/13/2021
Market Cap	$24.6 B
PE (fwd)	8.7
Short %	4.51%
Current EQ Rating	4+ (Acceptable)

We recommend readers refer back to our original report for our complete thoughts on URI. We think URI's accounting quality is very strong and the company is not as cyclical as many think. Half the business comes from non-cyclical construction such as transportation, large infrastructure projects, manufacturing plants, and energy production. Another 46% is commercial construction (which is cyclical) and remodeling. Very little has been related to residential home building. At the moment, and perhaps for the next several years – the large manufacturing plants for semiconductors, green energy, and infrastructure should be an increased percentage of the business. Much of that is either paid for by government or receives large government subsidies. 4Q22 adjusted EPS of $9.74 missed forecasts by 55 cents. Some one-time tax items that boosted the effective rate was 45 cents of the miss. We believe the remaining 10 cents was likely caused by the December acquisition occurring so late in the year. URI paused share repurchases ahead of that deal and closing share count only dropped from 70.1 million to 69.4 million from 3Q. An incremental 0.4 million shares would have helped EPS by 5 cents. Plus, the debt for the deal was issued before close, which added about 5 more cents.

- URI boosted its share repurchase plan to $1.5 billion after 4Q and is initiating a new $1.48 quarterly dividend giving a strong endorsement of how much strong the URI sees its current market.

- URI boosted guidance for 2023 calling for 20%+ growth in revenues, EBITDA, and free cash flow. Free cash flow is expected at over $2 billion, which more than covers the new $400 million dividend.

- Debt-to-EBITDA finished at 2.0x, but that is skewed by the acquisition closing so late and providing little EBITDA in 2022. Adjusting for that, Debt to EBITDA was closer to 1.7x, which is below URI's target level. We still think the heavy capital spending makes EBITDA a less compelling part of the ratio as much of depreciation is a cash expense here. But the level of debt to operating stats has been declining steadily. Forecasts are for Debt to EBITDA will decline to 1.5x in 2023 as URI plans to pay down more of its variable rate debt this year.

- The latest acquisition continues URI's policy of rapid amortization of intangibles at 3-5 years. Even though it adds back this amortization to non-GAAP results, the short expense period means the spread between GAAP and non-GAAP shrinks quickly. Also, only 23% of the deal was assigned to goodwill.

- The was a surge in prepaid expenses/other assets – the bulk of that is related to an income tax receivable related to depreciation on the December acquisition that should come in during early 2023. We don't see an issue there.

- Its fixed debt does not start to roll over until 2027 which should limit interest rate exposure.

- Inflation is still a positive for URI. While it boosts the price of new equipment, more customers opt to rent in that situation. Plus, URI sells used equipment early in its lifespan and higher new equipment prices help hold up used equipment prices too.

- It's not often URI trades at 5x EBITDA and under 9x forward EPS as it ramps up the amount of cash it returns to shareholders.

On Deck Values

Ball Corporation (BALL)

We see BALL as a real business that is caught up with short-term issues involving inventory, inflation, and customers' pricing. These areas may hurt results for another quarter or two. Then BALL may see reasonable growth rates of 10%-15% for a company trading for a depressed 17x forward earnings and 12x EBITDA.

- BALL's 4Q non-GAAP EPS of $0.44 per share missed by 11 cps as revenue missed too. North American revenue is being pressured by lower volume as beverage companies, particularly beer, raised prices and cut promotional spending which resulted in higher-than-anticipated unit sales declines.

- Cash flow remains pressured as the inventory buildup from lower sales and higher metals costs resulted in huge inventory balances that have yet to be monetized. CFO dropped to $283 million in 2022 from $1.8 billion in 2021 due entirely to working capital. The company expects a $200 million benefit during the year as contract resets will allow it to catch up on its cost pass-through provisions while costs hopefully decline.

- CFO Scott Morrison noted in the Q&A section of the conference call: "We still have too much inventory, and that's what we need to work off." This higher-cost inventory should be sold in the first half of the year which will pressure margins.

- Profits have also been pressured as efforts to control the inventory build have driven up per-unit costs. Margins will continue to be pressured towards the beginning of 2023 as high-cost units are expensed and the benefit of its cost pass-throughs will be limited until large contracts reset after 2Q23.

- We still need to watch that factored receivables jumped both sequentially and YOY despite the sequential drop in sales. BALL continues to boost its cash flow by more aggressively factoring despite rising rates making these programs more expensive. The company disclosed in the 10-K that the cost of its factoring program rose to $67 million in 2022 compared to $41 million in 2021 and $29 million in 2020.

- DSOs adjusted for factoring rose by 8.5 days sequentially and 4.3 YOY which could indicate revenue benefitted from late-quarter sales.

- Despite the increase in inventory, the company's reserve for obsolete inventory trended down in 2021. The reserve as a percentage of gross inventory now sits at 4% compared to its 6% level pre-Covid. We estimate it would take roughly 11 cps in charges to return the reserve to that level.

- After 3Q, BALL guided for a full-year tax rate of around 20% which would have required an approximate 21% rate for 4Q. The 4Q rate came in at 19.7% which was likely lower than what most analysts' models were expecting and could have added as much as 3 cps to EPS relative to expectations.

- We highlighted in the past how BALL increased the estimated useful lives for certain assets starting in 3Q which is adding about 6 cps to earnings per quarter compared to the old method. This non-operating earnings tailwind will continue for the next two quarters, at which point depreciation expense should begin to rise again as new assets come online.

OTIS Worldwide Corporation (OTIS)

The market follows new construction when it reads OTIS news. That is about 30% of sales (with lower margins) and has seen weakness, particularly from China for some time. OTIS saw new orders in China turn positive in 4Q22. It is still forecasting a negative volume figure for new orders in 2023.

The real story remains the service/maintenance/modernization part of OTIS. It is 3x the profit margin in addition to being 70% of sales. This type of business is difficult to postpone. OTIS has improved the digital monitoring of installed systems to diagnose repairs to reduce the time and labor for repairs. That is boosting margin here too.

For 4Q22, the non-GAAP EPS of $0.75 hit forecasts. The company is guiding to $3.35-$3.50 for 2023 vs. $3.17 in 2022. It appears to be ahead of commodity inflation at this point:

- Non-GAAP EPS does not exclude FX hits. For 4Q22, FX was an 8-cent headwind, which more than offset 2 cents from a lower tax rate, 2 cents from a lower share count, and 2 cents from adding in the Zardoya acquisition. The positive for 2023 is OTIS is only forecasting 9 cents of FX headwind for the full year. There was also a bump up in corporate expenses in the 4Q which OTIS expects to continue.

- 4Q22 EPS was also helped by bad debt expense falling from $10 million to $1 million – adding 1.5 cents to EPS. That was completely offset by share compensation rising by $9 million after declining in 3Q.

- Remaining guidance for 2023 looks doable. The company expects the FX headwind to decline by about 18 cents in 2023, an additional 4 cents from annualizing the Zardoya deal, $20-$30 million in lower commodity costs for 3-5 cents, 3-4 cents from repurchasing shares, another 50bp of margin gain in service for 7 cents. That's 37 cents of improvement without benefit from higher sales. The company still expects the first half of 2023 to be relatively flat.

- OTIS does have inflation clauses in North America and Western Europe to pass through higher labor and materials costs. That occurs on a lagging basis. The company expects to see a positive situation from price/cost in 2023.

- Receivables are up due to more billing coming later in the quarter as orders build. The peak was 92 days during Covid. OTIS was at 89 days after 4Q vs. 85 days in 3Q and up from 83 in 2Q22. We will continue to monitor this, and bad debt reserves have been declining.

- Payables jumped as OTIS prepaid suppliers to lock in deals. That continued in 4Q moving up another $196 million. We would like to see this start to decline in 2023 even though that would consume some cash flow. By comparison, inventories only rose by $14 million.

Stanley Black and Decker, Inc. (SWK)

SWK exited 2022 with weak consumer spending and DIY spending. It is forecasting a base case of -5% volume growth in Tools in the 1H23 and -3% to -3.5% for the 2H23. Margins are expected to remain weak in 2023 also but improve in 2H23. We still see this as a real company that historically benefits when people don't move as they reinvest in their homes.

SWK forecast for 2022 started at $12-$12.50 and came in at $4.62. Sales at retailers collapsed and inventory built up as sales values declined. Earnings are normally above $10 which makes the P/E under 7. It's under 7x normal EBITDA.

Near-term guidance is poor as SWK addresses past problems. SWK's plan includes:

- Organic growth of 2-3x its market with a 35% gross margin
- Streamline the cost structure in SWK and its supply chain by $2 billion
- Reduce SKUs and inventory levels to boost cash flow
- Pay down debt and reward shareholders with dividends and repurchases
- Inventory levels remain far above normal – peaking at 190 days vs. normal levels of 85-100 days. SWK purposefully built it up, but now business has slowed. This consumed cash flow and after entering 2022 with a forecast for $2 billion in free cash flow, SWK posted -$2 billion.
- SWK is now letting inventory decline and saw a steep drop in the 2H22 but remains at 165 days. It is forecasting another $750-$1 billion decline in 2023 and will reduce SKUs too. This will cause several near-term headwinds:
    - SWK is reducing production so sales exceed new supply and reduce inventory. But, this is unwinding operating efficiency, fixed costs are not being leveraged and gross margin has plummeted to under 20%. They are forecasting a return to 35%.
    - Reduced production means higher-cost raw materials are not declining much, and the inflation issues should continue to impact results for all of 2023.

    - Slowing unit sales are also reducing total cost of goods sold from initial forecast levels. Inventory DSIs get inflated because of this and it may take longer for DSI levels to reach normal levels.

- SWK continues to invest in the company despite lower sales. SWK is reporting higher advertising and R&D in dollar terms.

- One-time tax items benefited 2022 EPS that are unlikely to repeat. The first was an intra-company transfer of intangible assets that was a $153.3 million benefit. The second was a change in the valuation allowance for deferred taxes of $25.1 million. These two items added $1.14 in EPS to SWK's 2022 results of 4.62.

- Warranty accruals have been declining as new expenses lag settlements. This has been an earnings helper for several quarters with periods of negative net accrual to only $2-3 million. It's normally between $5-10 million. Every $5 million is worth 3 cents to quarterly EPS.

- The allowance for Rebates and Sales Returns declined with lower sales volumes in 2022 from $408.5 million to $376.6 million. We estimate this generated 18 cents in EPS and should be a headwind as volumes recover.

- Rising interest rates are a headwind. Interest cost for pensions were run on 2.28% in 2022. 300bp would cost SWK 25 cents. It has $2.1b in commercial paper, 300bp would cost it 37 cents.

- Goodwill is $8.5 billion with other intangibles of $4.5 billion at SWK compared to $9.7 billion in equity. SWK does not amortize goodwill or many tradenames. It has risks for impairments from using a higher discount rate.

The Scotts Miracle-Gro Company (SMG)

If homeowners show up in the spring to buy lawn care and gardening supplies then SMG should be fine. It is another company that built inventory in 2022 only to see demand drop from past growth rates. Still, there is some question as to how many new Covid gardeners will stick around and how elastic demand will be at higher prices.

- It has renegotiated its covenants to allow Debt-to-EBITDA to climb as high as 6.5x. Through cost-cutting and working down inventories it hopes to have its leverage ratio back in the 4s by next year. It announced today that it expects the ratio to stay comfortably below the credit facility covenant of 6.5 for the second quarter.

- Profits are not likely to dazzle given that low production rates are expected to contribute to lower gross margins again in FY2023. This year is focused on right-sizing inventory via reduced production.

- SMG has grown in past recessions as lawn care and gardening is a relatively cheap way for people to improve their homes compared to more expensive interior remodeling projects. Retailers are likely to help promote fertilizer and seed sales as it is a key driver of foot traffic into their stores.

- A near-4% dividend yield, which looks safe for now, compensates investors while they wait for what will likely be a bumpy turnaround in 2023.

Warner Bros. Discovery, Inc. (WBD)

The biggest battles for WBD are the advertising market that is weaker than 2021 and the much larger restructuring and culling after they took over from AT&T. Advertising is $10-$11 billion or about one-fourth of revenue. There were $3.8 billion in restructuring charges with many consuming cash. Plus, having largely completed content that it wrote off without releasing it for quality standards resulted in non-cash charges, but also reduced total revenues and operating income from initial forecasts. We see a company that still has work to do, but EBITDA growth should gain steam. The value of debt and stock is $82 billion (at $15 per share) and EBITDA was $9.2 billion in 2022 only 8.9x the low point.

- The streaming service is headed for a relaunch in weeks with better user interface. WBD has added more 3rd party methods to boost sales. WBD notes that peak losses on the service was 2022 at about $2 billion. They forecast breakeven by 2024 and $1 billion in EBITDA by 2025 – that's a $3 billion positive swing.

- Synergies are now expected to come in at $4 billion by 2024. They have been identified and many are already being achieved. Some of the streaming improvement is in that. That could be another $2 billion in positive swing from 2022.

- Accelerated amortization of poor content should be over – that penalized 2022. There is more content that will be released in 2023. Advertising remains a wild card and could get better or worse. Overall, there should be more revenues in 2023 and 2024 than in 2022 which will help EBITDA. WBD has rebuilt the sales team for advertising and that should be a positive contributor too. Adding advertising to streaming should help, and WBD can pitch a large portfolio of platforms to advertisers too.

- A lack of restructuring should help cash flow and allow more debt repayment. The goal is to retire $8-10 billion in debt to get the debt/EBITDA ratio to 2.5-3.0x in two years.

- This portfolio has traded for 10-11x EBITDA in the past. This management has a greater focus on boosting the cash flow margin. We think a very reasonable path exists here to get to $14 billion in EBITDA in 2024 and $15 billion for 2025 without relying on a big swing in advertising. That's 5.5-5.9x future EBITDA for WBD's current value.

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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