BEHIND THE NUMBERS
Quality of Earnings Analysis

7/8/2022

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Behind the Numbers 2Q '22 Focus List Part

Top Risks

On Deck Risks

Top Values

Company	EQ Rating	Date Added	
Air Products and Chemicals (APD)	4+ (Acceptable)	5/12/2022	p.28
AT&T Inc.(T)	4+ (Acceptable)	3/12/2021	p.30
LyondellBasell Industries N.V. (LYB)	*5+ (Strong)*	7/14/2021	p.31
Mowi ASA (MHGVY)	*5+ (Strong)*	12/4/2021	p.33
National Instruments Corporation (NATI)	*5+ (Strong)*	3/12/2021	p.35
Starwood Properties Trust (STWD)	*5+ (Strong)*	2/8/2022	p.36
Texas Instruments Incorporated (TXN)	*5+ (Strong)*	3/12/25021	p.37
United Rentals, Inc. (URI)	4+ (Acceptable)	12/13/2021	p.39

On Deck Values

Company	EQ Rating	Date Added	
Air Lease Corporation (AL)	4+ (Acceptable)	7/8/2022	p. 40
DocuSign, Inc. (DOCU)	4- (Acceptable)	7/8/2022	p.41
Lamb Weston Holdings (LW)	*5+ (Strong)*	10/12/2021	p.42
Otis Worldwide Corporation (OTIS)	5+ (Strong)	7/8/2022	p.43

Summary of Changes to the 2Q'22 BTN Focus List

Added to Top Risks

Cloudflare, Inc. (NET)	Added 7/8/2022
Colgate-Palmolive Company	Added 7/8/2022
The Hershey Company (HSY)	Added 7/8/2022

Removed from Top Risks

TransDigm Group Incorporated (TDG)	Removed 7/8/2022
Ecolab Inc. (ECL)	Removed 5/12/2022

Added to On Deck Risks

Ecolab, Inc. (ECL)	Added 5/12/2022

Removed from On Deck Risks

Patterson Companies (PDCO)	Removed 7/8/2022

Added to Top Values

Air Products and Chemicals (APD)	Added 5/12/2022

Removed from Top Values

Air Lease Corporation (AL)	Removed 7/8/2022

Added to On Deck Values

Air Lease Corporation (AL)	Added 7/8/2022
DocuSign Inc. (DOCU)	Added 7/8/2022
Otis Worldwide Corporation (OTIS)	Added 7/8/2022

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 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	$76.5 B
PE (fwd)	8.5
Short %	1.0%
Current EQ Rating	2- (Weak)

- MO looks cheap at first glance at these levels – It yields 8.75% (which is about 90% of the reason people own it) and trading for about 9x EPS. We still expect MO will cut its dividend sooner than later and there are too many guns pointed at its business model. MO has touted its move from cigarettes into new business areas for years now. Thus far, each move – JUUL, Cronos, IQOS, has proven to be a disaster and MO still gets 89% of its revenue and 86% of its operating income from smoking.

- We see MO addicted to price hikes for cigarettes to offset volumes declining at compounding 7%-8% rates. Marlboro used to take 15-cent price hikes. It took 43 cents last year. MO has benefited from state and local governments not boosting excise taxes much at all in recent years so nearly the full retail price increase for cigarettes flows to MO. How long will that last? With fuel and food inflation, smokers cannot afford to buy the same quantity of cigarettes. In 2021, before the full impacts of inflation – MO's dividend was 79% of free cash flow, the cushion was $1.75 billion. MO raised pricing on cigarettes last year by $1.7 billion to offset $1.9 billion in lost volume. There are several areas pointing to volume decay accelerating beyond even inflation.

- Menthol is about one-third of the smoking market (it is less at MO as it doesn't own Newport). California already passed a menthol ban and will now let voters decide in November if it takes effect. The FDA is also looking at banning menthol and has studied this for years. Massachusetts has a ban already too and many cities have passed one. This represents a large potential hit to cigarette volumes.

- Graphic health warnings go into effect in April 2023, these have been adopted by dozens and dozens of countries and have reduced smoking rates. People see the pictures many times a day, carry them around, and others who could become smokers see them as well. This could gap volumes down too.

- The FDA has been studying the impacts of cutting nicotine levels in cigarettes for years and is pushing more on the idea of reducing nicotine in the future. Studies have pointed to a large number of smokers quitting whenever this has been done. We have seen one that points to a 16% drop in smoking in the first year and 40% over five years.

- Lawsuits and the debt to buy JUUL and Cronos are still here too.

Cloudflare, Inc. (NET)

Date Added	7/8/2022
Market Cap	$16.5 B
PE (fwd)	Na
Short %	6.0%
Current EQ Rating	3- (Minor Concern)

- Several areas of NET's accounting are among the more conservative of its industry group such as a 3-year amortization period for capitalized sales commissions and a 2-year amortization period for developed tech in some acquisitions. Goodwill is still the largest allocation of purchase price.

- The problem we have is NET is one of the smaller players in this group with several showing profits already with greater economies of scale. NET doesn't even earn profits on its non-GAAP earnings now which add back stock compensation. Plus, it is the only one reporting negative free cash flow – which even under GAAP rules adds back stock compensation, and NET gets paid in advance in cash. Yet it still isn't posting positive free cash flow.

- With the stock collapsing from $217 to $50, we wonder if employees will want more NET stock? Recent awards occurred at prices well over $100. And employees were even diverting some cash wages toward buying NET stock at a discount. If employees demand more cash wages, that would lower free cash further and non-GAAP earnings would have a headwind from having more wages that cannot be added back. Will employees leave? Will they demand 3-4x the number of shares and create heavy dilution?

- NET also was using stock to make acquisitions and even more stock to settle the existing stock award programs for employees coming onboard. It paid $31.2 million in cash and stock for three deals. Those deals also included $35.9 million in future stock compensation to settle former stock awards. Since 2019, NET paid $202 million in stock compensation. In April 2022, it made a $162 million acquisition and expects to see $300 million in additional stock compensation just from that.

- NET's growth plan forecasts it will reach a 20% non-GAAP margin and it touts how much its non-GAAP margin has already improved. We noticed that it has taken stock compensation up by 700bp in this equation to record the higher non-GAAP margin and it appears that the 20% long-term forecast relies on stock compensation becoming a larger percentage of revenue.

- It’s worth noting that NET has $400 million of convertible bonds that it likely expected to pay with stock, but the conversion price is $191. It may be settling that with cash and it has negative free cash flow.

- It looks like if NET works according to its plans, the dilution here could be enormous. The share count rose from 146 million at the end of 2019 to $342 million after 1Q22. That was before the latest acquisition and before the stock price collapsed which may cause NET to offer even more shares to employees.

The Coca-Cola Company (KO)

Date Added	3/30/2022
Market Cap	$274.3 B
PE (fwd)	25.7
Short %	0.8%
Current EQ Rating	3- (Minor Concern)

- KO's non-GAAP EPS beat forecasts by 6 cents in 1Q22. The company did not boost guidance for revenue, organic growth, or EPS.

- Depreciation and Amortization declined by $42 million y/y and $17 million sequentially, this added 0.8 cents to EPS.

- Bad debt reserves declined by $4 million on a 32% increase in receivables. Had the reserve stayed the same percentage as December, EPS would have been 2.7 cents lower.

- Stock compensation did increase and was a 0.5-cent headwind.

- Organic revenue growth was heavily influenced by a 19% price hike taken in Latin America. We regard that as low-quality because it is due to hyperinflation in Argentina and should be viewed net of the FX loss. In all foreign markets, KO's FX hit was larger than its pricing gains except in Latin America. The comps for Latin America get increasingly tougher for the 2Q and 3Q when volume, pricing, and FX were all positive in 2021.

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

- Inventory issues remain a risk in our view. DSIs declined by 5.5 days y/y from 85.9 days to 80.4, and total inventories rose only 11% on 8% case volume growth. Inflation is likely running much hotter than 3%, and we believe KO is benefitting on margins by not replacing as much inventory and letting unit stocks decline. We noted earlier that DSIs look about 10 days too low, now that is 15 days lower than normal.

- Non-GAAP gross margin was down again despite the hefty price hikes. Gross margin fell from 61.6% in 1Q20 to 60.6% in 1Q21 to now 59.7% in 1Q22. We expect more gross margin pressure as inventories are replaced.

Conagra Brands, Inc. (CAG)

Date Added	10/8/2021
Market Cap	$16.5 B
PE (fwd)	15.0
Short %	3.2%
Current EQ Rating	2- (Weak)

- CAG's adjusted EPS of 58 cents met forecasts and the company reduced guidance. The company noted that inflation is running hotter than expected which is hurting results. They cut advertising to pick up 1.3 cents, another 0.2 cents from rounding up results, 1.2 cents from lower stock and incentive pay, and it has reduced third-party commission expense as part of its restructuring of the supply chain, which added another 1.1 cents. We point out the commissions because CAG is still saying supply chain issues are difficult and it has a tough time replacing inventory which may lead it to using more third-party brokers again.

- Its flour milling operation, which it spun off years ago because it was a lower margin operation and its ownership stake is now an equity method investment, produced an additional 5.6 cents in the fiscal 3Q22. Plus, only about 39% of the equity method earnings are coming in as cash.

- This is a boost to earnings that remains very lumpy because wheat prices have been rising since 2020 with some occasional large spikes and corrections. Wheat spiked very high after the 3Q22 ended so there may still be a larger bit of income in 4Q22 in May. CAG is guiding to 3 cents extra from equity method income in 4Q22 vs. the 5.6 cents in 3Q. These easy comps go away next year.

Equity Method Income	4Q	3Q	2Q	1Q
fiscal 2022		$48.1	$29.5	$20.2
fiscal 2021	$33.4	$21.5	$23.0	$6.5
fiscal 2020	$22.9	$10.4	$27.6	$12.3

- CAG uses FIFO accounting which should further be helping its margins amid inflation. However, it is having a tough time maintaining inventory balances. We also think investors should be asking why after years of restructuring and culling low-margin SKUs and lower-margin businesses are margins not seeing any improvement except during Covid?

Inventory DSIs	f22	f21	f20
1Q	90.1	77.1	92.8
2Q	73.6	70.3	79.9
3Q	72.7	71.6	80.3

Adj Oper. Margin	f22	f21	f20	f19	f18
1Q	14.1%	20.2%	15.7%	14.6%	15.4%
2Q	14.6%	19.6%	17.1%	17.5%	16.7%
3Q	13.7%	16.0%	15.7%	16.3%	15.0%

Colgate-Palmolive Company (CL)

Date Added	7/8/2022
Market Cap	$68.7 B
PE (fwd)	26.5
Short %	1.2%
Current EQ Rating	3- (Minor Concern)

- CL missed EPS targets by a penny in the 3/22 quarter and reduced guidance for the full year due to higher than forecasted raw materials costs.

- We previously warned that inventory trends were pointing to higher than expected costs. While DSIs increased in the 3/22 quarter, YOY inventory growth of 14.8% is likely not keeping up with the pace of raw materials inflation, which the company is now forecasting to be over 20% for the full year. This implies that on a unit basis, inventories may still be declining which puts the company in a position of replenishing at higher costs. With 75% of inventories accounted for under FIFO, it should be avoiding the full brunt of inflation by recognizing higher costs after price increases have gone into effect. We also believe the impact of liquidating LIFO layers may have helped offset some of the costs and limit the pressure on margins so far.

- Sales growth benefitted from prices rising 5.5% but volumes fell by 1.5%. The company is planning more price increases to offset higher costs. Target's disastrous margins will likely lead it to push back on higher prices from its suppliers and other large retailers are sure to follow. It seems very likely that CL will experience more elasticity with future price increases. In fact, North America was the only segment outside of pet food that saw positive volume growth in the quarter (only 1.5%) and it took prices ***falling*** by 1% in that market to generate the volume growth.

- CL saw a 3-cps boost in the quarter from lower advertising which hardly seems sustainable if it continues to increase prices.

- A drop in other expense/income added 1.9 cps largely from a VAT refund.

- As we expected, the company announced another restructuring charge in the quarter. These recurring charges cast doubt on the quality of non-GAAP earnings where the charges are added back. We will be watching for any expansion of the scale and duration of the plan beyond the original $200-$240 million size and mid-2023 completion date.

The Hershey Company (HSY)

Date Added	7/8/2022
Market Cap	$45.4 B
PE (fwd)	27.4
Short %	2.0%
Current EQ Rating	3- (Minor Concern)

- HSY beat non-GAAP EPS by 43 cents driven by revenue beating guidance by 6%. They boosted guidance by only 7 cents after the beat and the company is expecting tailwinds to reverse. At 27x forward EPS, we doubt HSY can withstand some disappointment.

- Revenue benefitted from retailers restocking inventory, a longer Easter season, and greater than expected price inelasticity. All of these tailwinds will fade over the remainder of the year.

- An unusual beneficial inventory valuation boosted EPS by about 8 cps. This will reverse in the upcoming quarters. Raw materials also continued to decline, foreshadowing inventory being replenished at much higher costs which will pressure margins quickly under LIFO. Management now expects 60-80 bps more gross margin erosion for the full year.

- Current forecasts do not incorporate more pricing action beyond what was announced by the end of last year. We believe rising costs may result in higher price increases which could hurt unit growth, lead to more market share losses, and require more advertising.

- Advertising expense fell in the quarter which we estimate added about 5 cps to EPS growth. We expect this will turn to a headwind in the back half, particularly if the company must raise prices further.

International Business Machines Corporation (IBM)

Date Added	3/12/2021
Market Cap	$126.9 B
PE (fwd)	14.1
Short %	2.4%
Current EQ Rating	2- (Weak)

- IBM normally beats forecasts but then releases its 10-K or 10-Q weeks later so that when it is possible to fully examine the quality of results, it seems like old news. Also, the Kyndryl spin-off following enormous charges has been helping IBM's revenue and earnings now for a couple of quarters. We believed investors should have been scared by IBM only beating by 1 cent in 1Q22.

- SG&A cuts added 2 cents to EPS. IBM continues to benefit from the huge 4Q20 workforce rebalancing change in 1Q22 as this expense fell $89 million y/y for 8.2 cents in EPS. Advertising was down y/y $9 million for 0.8 cents. These offset a $44 million swing for bad debt expense and a $28 million rise in stock compensation for 7.2 cents of headwind.

- Depreciation declined by $421 million y/y in 1Q22. Much of that change was Kyndryl being spun off. However, Kyndryl's depreciation was only $295 million in 4Q21 and $365 million in 4Q20. The range of the decline for IBM was $56-$126 million to add 5.2-11.6 cents.

- Retirement costs declined by $23 million y/y too – this added 2.1 cents to EPS.

- We are still concerned that IBM's R&D spending declined 60bp as a percentage of sales which added 7.0 cents to the 1Q EPS.

- The Free Cash Flow definition IBM uses leaves out acquisitions and includes selling used PP&E. We believe it already benefits from lower capital spending and IBM's business requires acquisitions for incremental sales growth and to keep R&D expenses modest.

- KD disclosed that IBM lost a court case with BMC Software in May. BMC was awarded $1.434 billion dollars by the court. The point is BMC sued IBM's managed infrastructure unit over events from 2017. That unit was spun off as part of Kyndryl. At this point, IBM is appealing the decision, but it is possible KD may be paying some or all of this penalty.

- KD’s results have been declining, but for IBM, KD is still a growth vehicle. It keeps selling more to KD, which KD passes through to its customers. As a result, KD’s revenues are declining, but IBM is pulling an increasing part of its revenue growth by getting a larger share of KD’s business. In 4Q21, KD’s revenues declined 7.5% from $4.9 billion to $4.6 billion (down $371 million) and KD wrote off $469 million in goodwill as margins fell too. IBM’s sales to KD rose by $549 million in that y/y comparison. In 1Q22, KD’s revenue fell another 7.1% y/y (down $340 million). But, IBM gained $685 million in sales to KD in the same period.

Iron Mountain Incorporated (IRM)

Date Added	12/4/2020
Market Cap	$14.3 B
P/FFO (fwd)	16.8
Short %	6.1%
Current EQ Rating	1- (Strong Concern)

- IRM beat 1Q22 forecasts for normalized FFO (Funds from Operations) by 1 cent coming in at 72 cents vs. estimates of 71 cents. AFFO came in at 91 cents. Both measures were down sequentially.

- FFO and AFFO both added 3.6 cents by ignoring the principal payments on financing leases. Both FFO and AFFO were helped by adding back 6 cents related to acquisition costs and losses in Ukraine.

- AFFO was helped by ignoring cash spending on fulfillment costs and customer inducement payments of 5.5 cents. Maintenance capital spending for AFFO declined $11 million sequentially and added 3.7 cents – yet AFFO still fell from 4Q21.

- Non-cash rent expense was added back to AFFO for 1.1 cents and IRM's estimate of what rent could be raised to in the future helped AFFO another 0.6 cents. Stock option expense was added back for 3.9 cents to AFFO.

- Operating lease expense rose 8.2% y/y with the recent sale-leaseback deals. Another acquisition for $718 million boosted debt further. If we reduce EBITDA by the cash fulfillment costs and principal payments on financing leases – Debt to EBITDA is 6.5x, which could rise further because IRM has a purchase obligation for the last 20% of that most recent deal.

- The cash flow statement continues to show a huge disconnect from AFFO, which is supposed to be a proxy for free cash flow. Even ignoring acquisitions, which IRM needs to replace attrition in its record business, the company only produces enough cash flow to cover the dividend in periods with very high asset sales.

- If it doesn't grow with acquisitions, IRM is going to trade a lower EBITDA multiple. At 13x, the stock would be under $35, at 11x under $24.

	1Q22	1Q21	2021	2020	2019
AFFO	$184.4	$181.0	$1,011.9	$887.5	$867.0
Cash from Ops	$54.5	$68.8	$758.9	$987.7	$966.7
Capital Spending	$161.1	$145.5	$611.1	$438.3	$693.0
Acquisitions	$717.9	$0.0	$204.0	$118.6	$58.2
Pymts for Business	$16.2	$19.1	$71.8	$75.0	$131.7
JV Investments	$0.0	$6.5	$78.6	$18.3	$19.2
Cap Lease Pymts	$10.4	$12.4	$46.1	$47.8	$58.0
+ Sale Leasebacks	$5.4	$12.4	$278.3	$564.7	$166.1
Free Cash flow	-$845.7	-$102.3	$25.6	$854.4	$172.7
Dividend	$184.4	$181.0	$718.3	$716.3	$704.5

Keurig Dr. Pepper (KDP)

Date Added	12/4/2020
Market Cap	$51.2 B
PE (fwd)	21.4
Short %	1.2%
Current EQ Rating	2- (Weak)

- Will rising interest rates unravel KDP? The company has only been hitting forecasts despite benefiting from taxes coming in below forecast, reduced marketing, lower R&D spending, and was guiding to a back-loaded year with coffee brewer and pod sales growth slowing significantly. However, KDP is uniquely at risk from rising interest rates in our view:

- It has $3.4 billion of its $4.5 billion in payables factored to banks. With total Days Payable at 284 days, we believe that KDP has effectively refinanced normal debt into payables knowing that working capital is often ignored when software calculates debt ratios.

- With short-term rates at almost 0%, this would have very minimal cost to KDP's suppliers. However, with 3-month LIBOR now 200bp up from 13bp last year and the 3-month SOFR rate now about 90bp up from 5bp last year – the suppliers may be asking KDP to start paying this bill. One way would be to boost what they charge KDP for raw materials and services to cover this which would cut KDP's gross profit margin. Another way would be to build interest costs into invoices that are paid after 30 days.

- Suppliers may require faster payment from KDP. That will effectively push the $3.4 billion in factored payables back onto KDP's bankline. KDP has a $4 billion dollar credit line with a rate between SOFR + 0.875%-1.5% which should be about 1.75%-2.4%. On $3.4 billion that be $59-82 million of additional interest expense or 3.3-4.5 cents in lost annual EPS. Whether suppliers go this route or higher prices to lower gross margin, we think KDP is looking at a headwind here for earnings and it is barely hitting forecasts now.

- The problem doesn't stop there on the payables. If they have to move it back to the revolver, then Debt to EBITDA which ignores payables rises from 2.8x to 3.7x overnight. That hurts KDP's deleveraging story. Also, boosting payables has been a huge source of cash flow for KDP. For 2021, cash from operations grew by $418 million, but $576 million came from stretching payables which was possible because suppliers sold an additional

$616 million of KDP’s payables. In 1Q22, cash from operations only grew by $117 million fueled by payables rising by $194 million, but suppliers sold an extra $215 million.

- There are $11.75 billion in notes payable at KDP as well. This is not a company with tons of liquidity laying around with its $590 million in cash. If it had to reduce its payables, or finance them for suppliers, they could use up most of the revolver they have in place. It has some sizeable debt maturities coming due fairly quickly: $1 billion due in May 2023, $500 million due in December 2023, and $1.15 billion due in March of 2024. It seems likely at this point that KDP may see interest costs rise on these refinancings too.

- We would also point out that KDP may have longer-term rising cost issues from all the sale-leaseback style transactions they have completed to generate cash and show a reduced debt to EBITDA figure. The money has been spent and the total lease payments are rising. Lease rollovers may also be happening on higher asset values that KDP’s landlord experienced with inflation and at higher imputed interest rates. This could continue boosting their ongoing cost structure too.

Mondelez International (MDLZ)

Date Added	12/4/2020
Market Cap	$86.5 B
PE (fwd)	21.2
Short %	1.2%
Current EQ Rating	2- (Weak)

- After beating or missing by 1 cent for several quarters, MDLZ beat by 9 cents in 1Q22. It raised revenue growth from 3%+ organic growth to 4%+ but lowered EPS growth from high-single digits to mid-high single digits. So 21x forward EPS and only a 2.2% yield.

- We have seen MDLZ letting inventory DSI's decline and that happened again in 1Q22 as DSI's were down two days. Adjusted gross profit fell 80bp. MDLZ uses average cost accounting so new inventories bought at higher prices impact immediately – just not as much as LIFO. Normally, there is a seasonality for 2Q where DSI's grow about 10 days. We expect the higher costs of inventory in recent months versus last year to further hurt gross margins this quarter. What was also interesting is raw materials were up $121 million (16%) sequentially, while finished inventories were up only 1.9%. Given the inflation, we think units are likely down which is more evidence that inventory costs should rise more going forward.

- Latin American price hikes are again boosting organic growth, which excludes the impact of FX. Normally the super price hikes are more than offset by huge FX losses. We have noted that MDLZ has had four quarters of easy comps coming that will make Latin American FX losses look much lower. Well, those easy comps are now gone:

Latin Am	1Q21	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Pricing	17.0%	15.1%	15.1%	14.9%	10.1%	6.4%	8.2%
Volume	8.7%	4.6%	10.8%	18.8%	-2.9%	-5.2%	-5.1%
Org. Growth	25.7%	19.7%	25.9%	33.7%	7.2%	1.2%	3.1%
FX Hit	-2.0%	-7.3%	-2.8%	-2.8%	-15.1%	-16.6%	-20.2%

It has tough volume comps coming and the level of price hikes have not been justified by high FX hits. We would not be surprised to see this area slow down. Last Quarter, Latin America was 11% of sales but was 30% of sales growth.

Post (POST)

Date Added	3/30/2022
Market Cap	$5.1 B
PE (fwd)	46.4
Short %	3.9%
Current EQ Rating	3- (Minor Concern)

- POST's adjusted EPS of 24 cents last quarter beat by 4 cents. That follows three quarters of misses, and the stock is now at a 5-year high with a forward P/E of 46, no dividend, and debt of over 6x forecasted EBITDA.

- POST cut advertising by $5.8 million which provided 7 cents alone and accounts for more than the entire earnings beat.

- We have warned that POST, even with FIFO accounting that should help margins during inflation has a problem because it has not been replacing inventory. The Inventory DSIs have been declining from the mid-50-day range to 43 days in 4Q21 and it recovered to 46 days in 2Q22 (ending in March). Inventory turns almost 2x a quarter, so inflation is getting to POST. Gross profit fell 345bp y/y. Sales rose 17.3% with gross profit in dollars only rising by 4.0%. Adjusted EBITDA that adds back about a dozen items only rose by 4.0% also.

- Remember, POST was basing guidance on inflation turning flat after 2Q22 and it has not reduced the EBITDA forecast.

- Also, POST still has its SPAC deal sitting out there. It now has about 10 months to make a deal. We remind investors that POST has had one great acquisition – BellRing. It is difficult to see any improvement from the many other deals completed at POST and the ROI has been 7% or less.

Sealed Air Corporation (SEE)

Date Added	12/4/2020
Market Cap	$8.6 B
PE (fwd)	14.1
Short %	1.3%
Current EQ Rating	2+ (Weak)

- SEE's 1Q22 beat by 19 cents. All of this can be seen in the price increases coming in above cost inflation in 1Q. Pricing of 16.1% added $204 million to revenue y/y for 1Q – SEE only beat revenue forecasts by $25 million. Guidance for revenue was only raised by $50 million for the year after the beat.

- Pricing exceeding cost inflation produced $98 million in EBITDA for the quarter, SEE only raised guidance for EBITDA by $10-$20 million for the year. The $98 million in EBITDA would have dropped to the pretax line too – it was worth 49 cents in EPS. Subtracting higher operating costs related to future growth projects of $30 million (15 cents) the price hikes would still net to 34 cents of EPS. SEE raised guidance for EPS by only 5 cents. Depreciation rose in 4Q21 without explanation and declined by $5.5 million in 1Q22 – this added 3 cents to EPS for 1Q22. Third-party consulting fees were again added back in 1Q22 – this was 2 cents of EPS.

- SEE does not expect this to continue and noted that the pricing gain of 1Q was the result of past price hikes announced in 3Q and 4Q of 2021 coming through for commodity items and formula pass throughs for commodities like resin. It expects to see 2/3 of the commodity inflation in 1Q and 2Q and moderate significantly in the 2H22. The formula pass-throughs should reduce pricing.

- It is still seeing higher labor and non-material costs – which rose $24 million in 1Q (12 cents of headwind) – those are expected to continue even if price/cost pass-through impacts for commodities lower revenues.

- The guidance for a 2% headwind from currency, looks low to us given that we believe a considerable amount of pricing and positive currency changes were seen in 2021 from Latin America.

- Volume comps remain tough for the next two quarters

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Food Vol.	1.5%	6.2%	5.7%	4.2%	-0.4%	0.3%	-1.8%
Protective Vol.	-3.2%	0.9%	3.8%	15.2%	13.0%	7.4%	21.4%

After 4Q21, SEE was forecasting 2%-3% volume growth. After 1Q22, SEE just posted a company-wide volume figure of -0.6% and it is talking about tough comps ahead. Plus, SEE is talking about supply chain issues making it tougher to drive volumes too. We think this could still be an area of disappointment which again makes pricing the only driver of growth. In fact, a case could be made that SEE would need more pricing to offset larger decreases in volume.

Sysco Corporation (SYY)

Date Added	6/11/2021
Market Cap	$44.0 B
PE (fwd)	26.3
Short %	2.1%
Current EQ Rating	3- (Minor Concern)

- SYY has rebounded strongly since Covid restrictions and 3Q22 (March 2022) saw earnings beat by 16 cents. Much of that came from strong revenue growth that also beat forecasts. It was troublesome that SYY only raised guidance the same 16 cents of 1Q's beat.

- SYY also added back a $29.6 million write-down of Covid-related inventories. This added 5 cents to EPS.

- SYY saw bad debt expense become a headwind again and it added back 1 cent in EPS from this. We believe this will continue after SYY benefitted from reducing credit loss expense for several quarters.

- We continue to wonder how long SYY can keep restructuring which seems to happen all the time. It added back another 3 cents in EPS from charges in this area for 3Q22.

- And it is still adding back the cost of acquisitions too. This grew to 5 cents of EPS in the quarter and SYY is basically telling investors that the deal was free.

On Deck Risks

Ecolab (ECL)

- We moved ECL to On-Deck because the inventory situation improved last quarter. ECL saw raw materials grow faster than inflation.

- We think investors should still have some concerns with the company at 31x earnings as it missed estimates by 1 cent last quarter. However, it picked up 5.0 cents by adding back the inventory it wrote down related to Covid sanitizer. It picked up another 7.5 cents by adding back the amortization of stepped-up inventory values related to the Purolite deal.

- The concern that remains is while inventory levels look much better, ECL uses LIFO accounting for about 30% of its inventory so it will have some of its most recent (and likely most expensive) inventory getting expensed first. ECL planned on boosting prices to all customers to reflect an energy surcharge. However, the timing on when that price hike would take effect was not known and may arrive AFTER the higher inventory costs start to be expensed. That could pressure margins.

Mohawk Industries (MHK)

- We are keeping MHK as an On-Deck name because the valuation is still low, it may be tougher to disappoint, and it beat in the April 2022 quarter by 89 cents.

- Receivables rose 13% sequentially but the allowance for discounts, claims, and bad debt was flat. This allowance fell 50bp sequentially and 128bp y/y. The 50bp drop alone added 11 cents to EPS. This allowance has dropped sequentially for six-straight quarters. This was the largest decline yet.

- Warranty reserves have been 2% of revenues for years at MHK. Not anymore. It is falling in dollar terms even with revenue dollars rising. It sits today at 138 bps, down from 164bp sequentially and 206 basis points y/y. Sales are up 9% sequentially and 13% y/y. Just the drop sequentially added 9 cents to EPS. This was again one of the largest sequential drops too.

- The amortization of costs to obtain contracts dropped sequentially from $17.6 million to $12.3 million, and y/y from $15.6 million That added 6 cents to EPS sequentially and 4 cents y/y. The $12.3 million amortization figure was the lowest in a long time too.

Teva Pharmaceuticals (TEVA)

- We keep TEVA on the On-Deck list because the stock price is so low as it bounces between $7-$10. It does hit $10 several times per year. It only met forecasts for 1Q22 at 55 cents which was down from 63 cents y/y. With GAAP EPS of -$0.86, the spread between GAAP and non-GAAP remains huge.

- TEVA drew down sales allowances in a huge way in the quarter – down $434 million which was almost twice the decline from 1Q21. Plus compare that $434 million figure to the decline of $583 million for all of 2021. The $434 million added 32 cents to EPS in the quarter. Also, when sales allowances fall, it boosts revenue. However, TEVA missed revenue forecasts by $93 million.

- The lower allowance also makes gross profit margin look like it is rising. In 1Q22, TEVA reported non-GAAP gross margin was 54.2% vs. 53.8% - that's already a very small gain compared to recent years of 80-90bp. However, we know costs would be the same whether sales are impacted by allowances or not. On gross sales, the gross margin was flat at 75.2%.

- Adjusted EBITDA, which adds back litigation costs, share compensation, impairments, and restructurings; declined y/y too from $1.206 billion to $1.135 billion in 1Q22. Also of note, even though free cash flow grew y/y from $59 million to $124 million, that's still a fraction of EBITDA. Does this look like a company where EBITDA is a realistic figure? In recent years, Free cash flow is about 40% of EBITDA.

- TEVA is still viewed as a company retiring debt to drive shareholder value. Investors are looking at Net Debt to EBITDA of $20.7 billion to $4.8 billion or 4.3x. It must retire over $6 billion in debt to reach the goal of 3.0x Debt/EBITDA. But, free cash flow is only about $2 billion per year.

Top Values

Air Products and Chemicals, Inc. (APD)

Date Added	5/12/2022
Market Cap	$88 B
PE (fwd)	21.3
Short %	1.2%
Current EQ Rating	4+ (Acceptable)

- From an earnings quality standpoint, APD gets high marks because it often reports the same figure for GAAP and Adjusted EPS. There simply are no adjustments. In periods when adjustments do exist, they truly are for one-time events such as relocating the headquarters, a change in government tax treatments for dividends, tax impacts for repatriation of cash, or closing a facility.

- The biggest quirk of earnings comes from plants it operates On-Site for customers, which is about half of revenues. These facilities have 15–20-year contracts and raw materials are passed through at cost– all commodity exposure risk is borne by the customer. This raises revenue and cost of goods sold by the same dollar figure. During inflation, it appears that gross margins are declining because of the inflated revenue figure. Gross profit in dollars can stay the same:

	Base	Inflation	Deflation
Revenues	$100	$130	$70
COGS	$70	$100	$40
Margin	$30	$30	$30
Margin %	30.0%	23.1%	42.9%

- For Merchant business, APD can see a lagging impact of costs changing faster than revenues. This commodity risk is typically short-term and APD changes pricing to offset it. The company was able to get ahead of the cost inflation in the March 2022 quarter the rate of changes for oil, gas, and various distillates and other feedstocks have slowed considerably since 2021.

- APD does hedge for interest rate risk and raw materials and marks to market. Most of these changes flow through Accumulated Other Comprehensive Loss, not EPS.

However, there are some positions not treated as hedges that DO IMPACT EPS – both GAAP and adjusted. We see this as non-material for 1-4 cents vs APD's $10 EPS.

- What makes this an attractive story is APD serves several growing markets such as hydrogen for fuel and power production, semiconductors, and low-carbon applications. APD has several new projects coming online over the next 4-5 years, many of which will come with long-term contracts and drive earnings and cash flow.

- The expected cost for growth is another $15 billion. APD is showing it is producing about $1.5 billion per year of free cash flow after the dividend to pay for much of this and has the borrowing capacity of holding Debt at 3x EBITDA or below to pay for the rest.

- Shareholders should enjoy a growing dividend during this period as well as rising EPS. Growth plans may expand further, or APD should be able to return more free cash flow.

AT&T (T)

Date Added	3/12/2021
Market Cap	$151 B
PE (fwd)	8.2
Short %	1.1%
Current EQ Rating	4+ (Acceptable)

- With the completion of the WarnerMedia spin-off, AT&T is down to a debt ratio of 3.1-3.2x (assuming $40 billion of lower net debt in April per the last conference call and slide presentation). AT&T was 3.4x vs. Verizon at 2.8x and T-Mobile at 3.0x. One of the big bear arguments against AT&T was its debt load. Debt should continue to decline via free cash after the dividend and minor asset sales continuing. The discount rate for pension benefit obligation rising from 3.0% to 3.7% in 2022 could also reduce PBO enough to make AT&T's pension fully funded.

- AT&T still has multiple ways to post steady and significant revenue, earnings, and cash flow growth. Much of this is already identified and is occurring. Time should help it grow:

    - Revenues can increase by having premium wireless customers increase as a percentage of the total, which has been happening. 5G should help that further and family plans from First Net subscribers. Also, by seeing international travel recover driving roaming fees that fell to practically zero. Broadband customers will see promotional plans roll off to normal fees. Much of those revenue growth paths should come with minimal incremental costs. AT&T continues to focus on boosting broadband service and should see new areas sign up a growing number of customers.

    - Expenses can decline too. AT&T should see leasing costs decline from turning off 3G infrastructure in early 2022. Phasing out copper should save $45-$50 per house and is a key part of AT&T's goal to pull another $3 billion out of its cost structure on top of the $3 billion already achieved. The falling debt figure should also save on interest expense – about $3-$4 billion.

- Right now, at $21, the market cap is $151 billion and there is $129 billion in debt. Trailing EBITDA is $40 billion or 7.0x. Over the next two years, we think the debt declines to $100 billion and the EBITDA becomes $45 billion based on revenue gains and expense cuts. At 7.0x EBITDA, the stock could hit $30, with a 5.3% yield on the $21.

LyondellBasell Industries N.V. (LYB)

Date Added	7/14/2021
Market Cap	$28.8 B
PE (fwd)	5.2
Short %	2.2%
Current EQ Rating	5+ (Strong)

- LYB is one of the biggest free cash flow generators we follow. The company also likes to use it to reward shareholders. It has retired 45% of its stock since 2013 and pays a dividend growing at 5% that is currently yielding 5.6%. After retiring $4 billion in debt in 2021, LYB noted that it would see even more of the free cash flow be returned to shareholders and paid a special dividend of $5.20 per share in June which amounted to $1.7 billion.

- The company's mid-cycle EBITDA was $7 billion in 2017, and with growth investments and acquisitions it is now $8 billion and should top $8.5 billion in 2023. That $8.5 billion would not include acquiring the other half of a JV. Mid-cycle is supposed to be an average year – the company is only 4.7x EBITDA and 4.4x 2023's. Free cash flow after the dividend and maintenance spending is $4-$5 billion to cover growth investments, repurchases, and additional dividends.

- We do not see this company as being nearly as cyclical as the market does. There are several reasons for this:

    - US shale gas and natural gas liquids give LYB a cost edge when Oil to Gas is > 8:1. Asia is the marginal cost producer so LYB is unlikely to lose profitability or orders.

    - Long-term demand should continue to grow as consumption per capita for plastics in developing countries rises by at least one-third to match Europe and even more to match the U.S. Consumer products and packaging use plastics.

    - Chemical plants go off-line for maintenance capital spending so the total name-plate capacity is seldom fully available from the supply side.

    - Inflation makes new plants more expensive and plants are frequently delayed by years. Supply has already been lagging demand for almost two years now. LYB's

Days of Inventory still look low as they have been unable to meet all the orders or rebuild stocks.

- We were concerned rebuilding inventory levels could consume as much as $1 billion of cash flow. The feedstock costs are not growing at the same rate as late 2020 and 2021. Getting back to 55 days of inventory from the current 41, may not require $1 billion now.

- If feedstock prices decline, we would expect LYB to report a Lower of Cost or Market charge to inventory. This would be a non-cash item. Historically, this is the largest part of LYB's adjustments to EPS.

Mowi ASA (MHGVY)

Date Added	12/4/2021
Market Cap	$11.9 B
PE (fwd)	15.8
Short %	NA
Current EQ Rating	5+ (Strong)

- Free cash flow net of maintenance and growth-oriented capital spending plus working capital growth, is more than twice the dividend. The dividend is growing and yielding 2.9% now. Debt is only 1.5x EBITDA.

- Salmon consumption remains very low – 1.7kg per capita in the US, 0.6kg in Japan, 0.1kg in China/HK. Total protein consumption is rising worldwide and demand is growing faster than supply for salmon. Farm-raised salmon is still a niche market. The world is eating about 2 million tons of farmed salmon per year vs. 70 million tons of beef, 109 million tons of pork, and 129 million tons of poultry. Protein consumption from animal sources is rising. The wild salmon market is declining and many other wild sources of fish are too. It's possible to grow the farmed salmon market and not even need people to switch from beef or chicken to salmon.

- Mowi's growth investments will allow it to boost its own supply steadily for many years and it has brand names and consumer products that allow for premium pricing. It has already doubled German consumption per capita and has just started the same plan in the US. Every 20% increase in US per capita consumption requires 110,000 more tons of farmed salmon, or 5.5% of world supply. China/HK is about 80,000 tons of consumption now and tripling that would only move per capita consumption to 0.3 kg/per year. Demand is already exceeding supply.

- The industry has consolidated into more of an oligopoly and has several barriers to entry including few geographic places to viably have a salmon pen, licenses are limited by governments, and it requires heavy upfront capital to open new facilities. The only way to grow meaningfully is to turn the fish in the pens more rapidly – which means building freshwater pens to raise fish to a larger size before they go sea. Mowi has been expanding its freshwater capacity already and plans to keep doing so through 2026.

- Other investments will allow it to reduce costs per kg of salmon produced. Mowi has seen good success in this area already.

- Mowi trades in NOK in Norway, and its ADS in the US trades in dollars. Norway produces lots of oil and the last time oil prices were well above $100, the NOK was about 5 to the dollar. Since oil fell from $100+ in 2014, the NOK has been 8.5-9.0 to the dollar, other than spiking to nearly 12 early in Covid. At the current 10x and oil at $100, we think the NOK has more reason to strengthen than depreciate. Appreciation of the NOK moves the ADS's price up in dollar terms and vice versa. The NOK rising to 8.5x is about an 18% positive move in the ADS price.

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National Instruments (NATI)

Date Added	3/12/2021
Market Cap	$4.1 B
PE (fwd)	15.3
Short %	2.0%
Current EQ Rating	5+ (Strong)

- NATI has the same recent problem as TXN – the shutdowns in Shanghai late in 1Q and into 2Q22 disrupted order deliveries. This grew backlog to 8 weeks vs. the normal 1 week in 4Q20. We have already seen in 4Q21 when the backlog dropped from 6 weeks to 5 weeks that the extra revenue produced record sales and margins. The 2Q22 guidance at the low end of $370 million assumed Shanghai was closed the entire quarter and that didn't happen. At 15x EPS, we think this is a great entry point for NATI. It also has a 3.6% yield that is growing.

- Another positive for NATI is it has been able to rebuild its inventory back above 240 days vs. 167 at the low point. The shutdown meant it couldn't deliver products to a closed customer. It had record orders in 1Q21. Like TXN, NATI focuses on avoiding out-of-stock situations as its products do not erode in value and they believe the ROI of an incremental sale exceeds the cost of carrying extra inventory. It has also been redesigning parts with customers to take advantage of chips that are not in short supply, so its inventory may be more flexible now as well.

- Also like TXN, NATI tends to invest in overhead costs such as R&D and marketing and letting revenue be the wildcard. When backlog grows, margins shrink as overhead costs don't leverage as well, but the reverse is true as revenues bounce back. NATI has also penalized itself with a jump in bonus pay/variable compensation after the reopening after Covid and that growth in expense should be much more muted going forward as revenues recover.

- NATI now has 20% of its sales from software and services which reduces its reliance on chips a bit from where it was a few years ago and this adds to margins as well.

- Our only earings quality problem with NATI remains that it adds back amortization of acquired intangibles and stock compensation. China risk remains, but we believe the stock has that priced in heavily.

Starwood Property Trust (STWD)

Date Added	2/8/2022
Market Cap	$116.3 B
PE (fwd)	9.8
Short %	1.0%
Current EQ Rating	5+ (Strong)

- Higher interest rates help income. A 200bp increase in LIBOR adds about 11 cents to EPS as it has a 98% floating rate loan book. It also has LIBOR floors on many of its loans with a weighted average of 57bp in 1Q22 – as it breaks through those floors, STWD will capture more of the interest rate rise.

- STWD does not rely on warehouse lending, it matches durations, it has fixed-rated debt, or uses interest caps and hedges. It emphasizes off-balance sheet financing too with securitizations and CLOs which removes mark-to-market risk. It has a low Loan-to-Value on assets and $3.8 billion in unencumbered assets it can tap for further liquidity. It has a very defensive balance sheet.

- Its apartment properties in Florida are seeing rent increases that are tied to incomes and backward-looking inflation figures so recent inflation is not fully in rents yet. Once rents are raised, they cannot decline. STWD owns 79.4% of these properties through an investment vehicle that has it mark the investment to fair market value. This should produce more gains.

- STWD does not have losses to shield gains on its property book. Higher gains mean higher income and as a REIT, STWD must pay out 90% of GAAP income. STWD yields 8.5% now on current stock prices and appears likely to see the dividend rate increase because of gains in this area. STWD expects to determine this policy at year-end.

Texas Instruments (TXN)

Date Added	3/12/2022
Market Cap	$137 B
PE (fwd)	16.5
Short %	1.7%
Current EQ Rating	5+ (Strong)

- TXN has been beating forecasts with high earnings quality. TXN only adjusted its EPS for 7 cents per quarter related to start-up costs for a new plant and that adjustment should disappear in 3Q22.

- The wild card here has been revenues, TXN invests essentially the same amount on R&D and overhead each quarter. Revenue either rises and leverages that spending, or revenue declines and margins decline too as flat expenses are spread over lower revenues. TXN's stock was beaten up after 1Q22 because it lowered this quarter's revenue guidance by 10% due to Chinese Covid lockdowns when customer plants were closed and couldn't accept chips. This is expected to grow TXN's backlog further. We expect 10% lower revenue to cut gross margins by 100-150bp from 1Q22 to 2Q22.

- A positive aspect is TXN should show an improved inventory position. That should help it to meet more of the backlog. DSI's bottomed at 113 days in 2Q21 and grew back to 128 days in 1Q22. TXN was not stopping production during the Chinese lockdown and its goal is to return to 130-190 days of inventory.

- We do not believe TXN is getting an enormous amount of double-ordering that will be canceled from backlog as chip shortages are cured. For several quarters, TXN has openly stated that customers are not ordering everything they can via panic buying. Customers have been more orderly for 4-5 quarters now and are focusing on specific chips needed to complete sets of chips and finish end products. They are not seeing total quantities of orders that are out of line with current demand. Also working against the double-ordering concerns is TXN has reported chip prices are still rising.

- TXN should still benefit from working down backlog that will create a situation where it is meeting current and pent-up demand and revenues should increase again over fixed overhead costs and leverage margins.

- 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 (URI)

Date Added	12/13/2021
Market Cap	$17.5 B
PE (fwd)	8.3
Short %	3.9%
Current EQ Rating	4+ (Acceptable)

- 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.

- 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's headline debt/EBITDA was 3.0x in 2018 and 2.2x in 2021 – which does not have a full year's contribution from the acquisition. By our method of taking the net cash outflow of buying new rental equipment less equipment sold, the debt ratio was 4.8x in 2018 and 3.7x in 2021. It's still moving toward lower total debt.

- Investors are shunning URI of late fearing recession and lack of construction. That ignores that customers may turn to URI MORE during that scenario. Customers can use URI's balance sheet to gain access to newer equipment rather than buy their own or buy used. Inflation should make that a better proposition too and the value of URI's assets could increase.

On Deck Values

Air Lease Corporation (AL)

- AL makes its money primarily in two ways – leasing planes and recycling capital by selling used planes. We are moving it to an On-Deck Buy because the delays from Boeing and Airbus in delivering new planes continue. A lack of new planes has also led AL to delay some of its aircraft sales and that source of revenue and profits was essentially gone in 2020 and 2021 (until 4Q) and is expected to be modest and back-loaded in 2022.

- Two sources of recent EPS growth are not what AL would have wanted. When Russia nationalized leased airplanes, AL grabbed the security deposits which added 52 cents to EPS in 1Q22. Also, AL had a 2-cent credit for stock compensation because it cut the forecast on how much stock would be awarded.

- After 1Q22, the Russian situation should also mean a small reduction in lease revenue as AL will not accrue rent on those planes. However, the planes are insured, and AL should see some settlements there eventually that will flow back to AL as income.

- The bigger picture here still looks very compelling to us and we believe that AL has been unable to fully utilize its larger balance sheet in a temporarily reduced airline market. This still looks like a company that can earn $5+ in EPS going forward, so the stock is 6-7x EPS and trading for almost half of book value (56%). Furthermore, the book consists of cash and young, fuel-efficient planes that remain in high demand and are the work-horses of fleets.

- Deferred rent from Covid continues to decline. Repaying past rent deferrals is helping revenue growth now. Also, leases have interest rate escalators in them while 95% of AL’s debt is fixed. So, the higher interest rates should help revenue.

- Guidance is for backloaded aircraft sales in 2022 of $750 million which compares to only $138 million in 2021. AL’s operating model is to sell planes while they are still only about 7-9 years old and still seen as very modern. This source of revenue and income is lumpy, but it should see some bounce this year.

- The delays at Airbus and Boeing caused many airlines to cancel orders and recover deposits. AL believes some of those orders are not fully completed due to a lack of parts. Therefore, AL may have 50 planes due for delivery, but could only get 30 of its order filled due to delays. However, it may be able to also buy some of the canceled orders of others more rapidly and in better deals.

DocuSign, Inc. (DOCU)

- DOCU relies heavily on paying wages with stock, which it adds back as non-GAAP EPS. Long-term forecasts call for $5 billion in revenue and a 20%-25% non-GAAP operating margin which translates to $4-$5 in EPS for a stock now in the low $60s. It has seen many people leave as the stock fell from $300. We have this as an On-Deck idea because we want to see more evidence that its new hiring will pay off.

- DOCU has two accounting issues: stock compensation is over 20% of revenues and it capitalizes and amortizes some initial sales commissions over five years. It has already achieved its long-term non-GAAP margin guidance last year, but it came entirely from adding back stock compensation – will employees still want DOCU stock at this point vs more cash? More cash is a headwind for non-GAAP margins. And if employees accept stock, will they want so many more shares that it dilutes investors' returns. More of the commissions should be coming from renewals, which are capitalized over 2 years or the contract term - that could create an expense headwind for margins too. These two questions also make this an On-Deck idea while we look for more clarification.

- Bigger picture – DOCU is a high-margin software company with solid cash flow because it is paid in advance in cash. Its sales growth for electronic signature, documentation, and security was jumpstarted by Covid shutdowns to be sure. But, its retention rate for existing clients is still over 100% indicating it is not only keeping clients, those clients are buying more from DOCU each year. Even with the reopening, there is still a time advantage for some parts of the sales process using electronic methods. It has tie-ins with Google, Microsoft, Oracle, SAP, Salesforce, et.al. So we see the potential growth rate for revenue as strong.

- DOCU is forecasting it will have 10% of a $50 billion market in a few years. The sales force is being professionalized now with the focus of growing more via larger customers and adding new divisions within those companies. Sales teams want faster documentation, Human Resources can manage out-of-town employees easier this way, and Legal can analyze warranties and contracts more quickly.

- The turnover of its sales team hurt revenue growth in the last couple of quarters and DOCU's guidance was poor for the current period with Billings almost equal to Revenues. We believe DOCU could start to see this situation improve as more of its new staff is better trained, but this is something to watch.

- As much as we think adding back stock compensation is a big knock against earnings quality here, we did note that DOCU recently became free cash flow positive even if all wages were paid in cash. Perhaps that can improve more as the company matures further and revenues grow.

Lamb Weston Holdings, Inc. (LW)

- This is still an interesting company with several areas that can improve. However, it remains an On-Deck idea as we think too much of the improvements are priced in at this point. Pre-Covid, LW could do about $940 million in EBITDA and with debt and the current stock price, LW is trading for just under 14x normal EBITDA point and it's not generating normal EBITDA yet. Net debt under 2.5x is not an issue, but the mere 1.3% yield does not justify it either at this point.

- Raw material prices are still rising and LW agreed to a 20% increased price for potato farmers for fiscal 2023. LW is still guiding to higher transportation costs to pressure EBITDA. Poor crop quality has been the problem the last two years which results in less output per potato. LW does see that enough acres will be planted but cannot give color on crop quality yet.

- LW's efforts to cut operating costs have improved margins – we still believe those gains, plus a normal potato quality year can show up with better margins too, and the recovery in higher-margin foodservice volumes at the expense of lower-margin retail should further help margins and EBITDA recover. Higher prices should leverage some fixed costs too and help margins.

- LW is still adding capacity in Idaho and China, which is pushing up capital spending. That too should help boost normalized EBITDA figures.

- Working capital has been a drain this year so far. Cash from operations is down $200 million y/y and $148 million of that decline has come from cash drain related to higher receivables and inventory and a decline in payables.

- It is an interesting story with some long-term growth potential but we would want a better entry point given some of the open questions at this time.

OTIS Worldwide Corporation (OTIS)

- There is an interesting long-term growth story here. About 80% of the sales are recurring service/maintenance and upgrading/modernizing existing elevators and escalators with the other 20% related to new construction. Some upgrades can be postponed but the service/maintenance cannot. Service revenue is seeing mid-single-digit growth on a total sales base of about $14.5 billion. The goal is also to streamline costs and boost margins from 14% to 20% with about 30-50bp of improvement per year. Much of that will come from digital diagnosis which reduces travel and the number of visits with service and repairs. Staff is lower overall and there are signs of improvement already with margins up about 100bp so far.

- We're making this an On-Deck Buy as it does get half its new construction spending from China. Also, exposure to other markets in the world for even maintenance is creating problems such as its small Russian business. New construction also gets hurt when interest rates increase and Covid still has many buildings around the world not fully occupied as many employees continue to work at home. Even growing businesses may be seeing less demand for real estate as they have fewer people in the office full-time. The new construction market could be constrained and provide headline risk for the stock.

- The company is retiring debt - $500 million recently. Debt is only 2.27x EBITDA and OTIS wants to continue bringing that down and pay a dividend of 40% of earnings. The yield is 1.6% and growing at 20%. We like that restructuring costs are low vs. the benefit – it's not spending $2 billion to cut annual costs by $250 million. This was designed to save $650 million (largely through lower wages) and is only costing about $50-$70 million per year for four years. OTIS still saw 30bp of margin gain in 1Q22. It needs to grow into its valuation which is currently 22x EPS and just under 15x EBITDA.

- We think the risks of percentage completion are low given that it only impacts new construction, and most sales are completed within 12 months. Having recognition of revenue pulled forward or delays only moves the EPS by a few cents vs. EPS of $3.01 in 2021.

Explanation of EQ Rating Scale

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

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

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

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

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

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

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

Key Points to Understand About the EQ Score

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

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

Disclosure

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