BEHIND THE NUMBERS
Quality of Earnings Analysis
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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Behind the Numbers 2Q '23 Focus List

Top Risks

Company	EQ Rating	Date Added	
Altria Group (MO)	2- (Weak)	6/11/2021	p. 4
Cloudflare, Inc. (NET)	2- (Weak)	7/8/2022	p. 6
The Coca-Cola Company (KO)	3- (Minor Concern)	3/30/2022	p.10
Dentsply Sirona Inc. (XRAY)	2- (Weak)	4/10/2023	p.12
International Business Machines Corporation (IBM)	2- (Weak)	3/12/2021	p.14
Iron Mountain Incorporated (IRM)	1- (Strong Concern)	12/4/2020	p.17
Keurig Dr Pepper Inc. (KDP)	2- (Weak)	12/4/2020	p.19
Mohawk Industries, Inc. (MHK)	2- (Weak)	9/27/2022	p.21
Post Holdings, Inc. (POST)	3- (Minor Concern)	3/30/2022	p.23

On Deck Risks

Company	EQ Rating	Date Added	
Becton, Dickinson and Company (BDX)	3- (Minor Concern)	4/10/2023	p.25
Cintas Corporation (CTAS)	3- (Minor Concern)	12/2/2022	p.26
Okta, Inc. (OKTA)	2- (Weak)	7/14/2023	p.27

Top Values

Company	EQ Rating	Date Added	
Air Lease Corporation (AL)	4+ (Acceptable)	9/27/2022	p.28
Air Products and Chemicals, Inc. (APD)	4+ (Acceptable)	4/10/2023	p.31
Costco Wholesale Corporation (COST)	*5+ (Strong)*	12/2/2022	p.33
LyondellBasell Industries N.V. (LYB)	*5+ (Strong)*	7/14/2021	p.35
Philip Morris International (PM)	*4- (Acceptable)*	4/23/2023	p.37
Starwood Properties Trust, Inc. (STWD)	*5+ (Strong)*	2/8/2022	p.39
Texas Instruments Incorporated (TXN)	*5+ (Strong)*	3/12/25021	p.41
United Rentals, Inc. (URI)	4+ (Acceptable)	12/13/2021	p.43
Warner Bros. Discovery, Inc. (WBD)	3+ (Minor Concern)	5/8/2023	p.45
Wesco International Inc. (WCC)	5- (Strong)	5/15/2023	p.47

On Deck Values

Company	EQ Rating	Date Added	
AT&T Inc.(T)	4+ (Acceptable)	7/14/2022	p.49
Ball Corporation (BALL)	3- (Minor Concern)	9/27/2022	p.51
DocuSign, Inc. (DOCU)	*4- (Acceptable)*	7/14/2023	p.53
Kimberly-Clark Corporation (KMB)	4+ (Acceptable)	7/14/2022	p.55
The Scott's Miracle-Gro Company (SMG)	4- (Acceptable)	9/27/2022	p.56
Stanley Black & Decker, Inc. (SWK)	3- (Minor Concern)	4/23/2023	p.57

Summary of Changes to the 2Q'23 BTN Focus List

Removed from Top Risks

Medtronic plc (MDT)	Removed 7/14/2023
Sealed Air Corporation (SEE)	Removed 7/14/2023
Teva Pharmaceutical Industries Ltd. (TEVA)	Removed 7/14/2023

Added to On Deck Risks

Okta, Inc. (OKTA)	Added 7/14/2023

Added to Top Values

Warner Bros Discovery Inc. (WBD)	Added 5/8/2023
Wesco International Inc. (WCC)	Added 5/15/2023

Removed from Top Values

AT&T Inc (T)	Removed 7/14/2023
DocuSign, Inc. (DOCU)	Removed 7/14/2023

Added to On Deck Values

DocuSign, Inc. (DOCU)	Added 7/14/2023
Kimberly-Clark Corporation (KMB)	Added 7/14/2023

Removed from On Deck Values

Otis Worldwide Corporation (OTIS)	Removed 7/14/2023
Warner Bros. Discovery, Inc. (WBD)	Removed 5/8/2023

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	$81.6 B
PE (fwd)	9.1
Short %	0.9%
Current EQ Rating	2- (Weak)

- Adjusted EPS continues to add back litigation costs, even though Altria has been in court for decades. It added back 4 cents in 1Q23 in a quarter that beat by 1 cent.

- Higher interest rates are cutting pension income – from $44 million to $10 million in 1Q23 – a 1.4-cent headwind that should continue to impact 2023 income.

- MO cut EPS guidance from $4.98-$5.13 to $4.89-$5.03 after the NJOY deal. MO does not expect accretive EPS from the deal until 2026.

- ABI investment is still above the carrying value after multiple impairments – carrying value was $9.2 billion and fair value is $11.0 billion now (BUD stock would need to drop below $47 for this to be an issue again). But now watch out for *Copenhagen* and *Skoal.* They are shedding volumes and even with price hikes – earnings are not growing.

Skoal Vol.	4Q	3Q	2Q	1Q	Coph Vol.	4Q	3Q	2Q	1Q
2023				-8.2%	2023				-5.4%
2022	-11.7%	-5.0%	-10.3%	-8.9%	2022	-11.3%	-2.6%	-8.2%	-6.3%
2021	-4.1%	-8.8%	-2.4%	-6.0%	2021	-1.7%	-7.4%	-3.5%	-1.7%
2020	-4.3%	-6.1%	-7.9%	2.0%	2020	-1.3%	-3.0%	4.7%	-0.2%
2019	-5.3%	-6.7%	-2.7%	-8.5%	2019	-3.3%	-0.4%	-3.9%	0.6%

There is $5.1 billion in goodwill for these units and $9.1 billion in other intangibles – that includes $3.9 billion for the *Skoal* trademark. In December, MO determined that the value of *Skoal's* trademark exceed the $3.9 billion by 12% - but if the discount rate used was 100bp higher, it would exceed by only 2% or $78 million. Volume decay has offset the pricing gains MO has taken for this unit as adjusted income has declined.

Oral Income	4Q	3Q	2Q	1Q
2023				$416
2022	$370	$425	$430	$407
2021	$390	$405	$472	$429
2020	$412	$440	$456	$416
2019	$395	$442	$422	$367

- Smoking volumes were down 11% in 1Q23 – continuing the accelerated decay. MO said competition is aggressively pricing in discount brands also that promotional spending is returning. Promotional spending will reduce total pricing gains. Despite $472 million in pricing in 1Q23 without low promotions – smoking income is flat:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Smoking Op. Income	$2,515	$2,603	$2,812	$2,800	$2,511	$2,504	$2,761	$2,784

- The FDA is expected to announce a nationwide menthol ban in August – effectively taking effect in 24 months. Appellate court actions are expected this summer on graphic packaging for cigarettes – both could lower forecasts for cigarette volumes.

Cloudflare, Inc. (NET)

Date Added	7/8/2022
Market Cap	$21.3 B
PE (fwd)	Na
Short %	6.4%
Current EQ Rating	3- (Minor Concern)

NET's 1Q23 adjusted EPS of $0.08 was both positive (a rarity) and beat forecasts by 5 cents. It also reported positive free cash flow of $13.9 million. In both situations, we see several items that point to unsustainability. Guidance for 2023 was raised from 15-16 cents to 34-35 cents on lower revenue - that also looks suspect:

- NET guided to an effective tax rate of 36%. It came in at 12.4% That was worth 2.1 cents. For 2023 guidance, the new effective tax rate is 9% which added 10 cents to guidance.

- Interest income with higher interest rates was 3.5 cents of 1Q23 adjusted EPS. While that is real income – we continue to question how many people own NET at nearly 200x forward adjusted EPS to collect interest income. It is almost half of adjusted income and is also helping guidance.

- Gross margin guidance is 75%-77%, NET came in at 77.8% and is noting that sales are taking longer to close. This added 0.8 cents.

- Cash R&D and Selling costs both increased y/y and sequentially but declined as a percentage of sales adding 1.0 cents and 0.6 cents to adjusted EPS.

	1Q23	**4Q22**	**3Q22**	**2Q22**	**1Q22**
Cash R&D	$51.3	$49.4	$46.4	$46.2	$40.3
% of sales	17.7%	18.0%	18.3%	19.7%	19.0%
Cash Sales/Mrk	$120.6	$113.0	$103.5	$103.9	$89.7
% of sales	41.5%	41.1%	40.8%	44.3%	42.3%

The ramp in selling and marketing is by design and looks real. We are OK with that. But another red flag is even NET admits sales were back-loaded, which it expects to continue. This could quickly become a headwind for margins. NET cut sales guidance $50-$58 million.

- Sales growth was backloaded and deferred revenue growth is faltering. NET is complaining of a longer sales cycle as many customers are conserving cash. It forecasts the same for 2Q and 2023. At the same time, Artificial Intelligence companies are rolling out at accelerated rates, are getting funding, and are buying security products including NET's offerings. Yet, sales growth is still showing signs of slowing. What if AI growth drops even a little?

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Sales	$290.2	$274.7	$253.9	$234.5	$212.2	$193.6	$172.3	$152.4
A/R	$179.7	$148.6	$126.9	$122.1	$125.4	$95.5	$84.7	$75.9
Def. Rev	$238.8	$218.6	$171.4	$155.8	$131.7	$116.5	$92.4	$79.8
A/R DSO	55.8	49.8	46.0	47.4	53.2	44.4	45.2	45.3
Def. Rev DSO	74.1	73.2	62.1	60.5	55.8	54.2	49.3	47.7
Retention %	117%	122%	124%	126%	127%	125%	124%	124%

  - The 6-day jump in A/R was worth about $20 million in 1Q23 sales, or as much as 4 cents to 1Q earnings.
  - Deferred revenue had a big jump in 4Q22 and leveled off. Given new orders, it still seems like it should have risen more.
  - Retention above 100% is still a positive sign. The 117% just indicates that existing customers are not expanding their usage at the same rate when it was 124%.
  - Guidance does not point to any of these situations improving in the near future.

- Another sign of slower sales is the contract acquisition costs. NET defers the cost of new customers and amortizes them over time. If the gap between new costs vs. amortization of older ones is rising, it should indicate faster growth. If it is narrowing, it should indicate slower growth:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Contract Acq cost	-$19.4	-$19.0	-$18.4	-$15.0	-$15.6	-$17.3	-$12.8	-$14.5
amortization	$14.1	$13.1	$11.8	$10.6	$9.7	$8.6	$7.8	$6.9
Net	-$5.3	-$5.9	-$6.6	-$4.4	-$5.9	-$8.7	-$5.0	-$7.6

- Positive Free Cash Flow is rare and the last two quarters saw some unusual items help that may not be sustainable. Free cash flow was $13.9 million in 1Q23 and $33.7 million in 4Q22:

    - 1Q23 saw capital spending drop to $17.5 million vs. $30-$40 million that alone eliminates 1Q23's free cash flow.

    - Both quarters benefited from $11.8 million and $7.5 million in interest income.

    - Spending on new software also looks about $1 million light in both quarters.

    - In most quarters, deferred revenue is a $15-20 million help and accounts payable is neutral to a small headwind for a net of about $17 million in cash flow. For 1Q23, NET had $11.6 million from higher payables and $21.9 million from higher deferred revenue for $33.5 million. For 4Q22, deferred revenue jumped $50.3 million and payables fell by $10.3 million for $40.0 million combined. Again, the excess in this area eliminates free cash flow for 1Q23 and almost for 4Q22.

    - The higher receivables of a back-loaded quarter didn't help 1Q23, but NET is saying that situation is continuing.

- Stock compensation remains a key item for NET. Without it, NET seldom has positive cash from operations, would never have positive free cash flow, and would not be profitable:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Sales	$290.2	$274.7	$253.9	$234.5	$212.2	$193.6	$172.3	$152.4
Stock Comp	$61.8	$62.6	$55.9	$57.5	$41.8	$42.1	$28.0	$24.1
% of Sales	21.3%	22.8%	22.0%	24.5%	19.7%	21.7%	16.3%	15.8%
Headcount	3,394	3,217	3,181	3,063	2,751	2,439	2,240	2,050
Stk/employee	$18.2	$19.5	$17.6	$18.8	$15.2	$17.3	$12.5	$11.8

    - This can be lumpy and employees had lower stock comp in 1Q23. It still posted 8 cents of adjusted EPS by adding back 19 cents in stock compensation. Adjusted operating margin is about 6%. To get there, NET is adding back stock

compensation of more than 21% of sales and acquired intangible amortization of 2% of sales.

- Stock compensation per employee has leveled off of late. It is worth monitoring this to see if NET needs to pay more cash wages and less stock as sales rise. That would effectively crimp adjusted margins. Every 100bp is worth about 1 cent per quarter in adjusted EPS.

- The Area 1 employees are still underwater with stock options that are exercisable at $93, it's been over a year for them.

- Remember the long-term forecast calls for a 20% adjusted operating margin. NET is at 6% now. The forecast calls for 100-200bp in lower gross margin and flat cash R&D as a percentage of sales. So NET needs to pick up 1600bp leveraging cash selling and general costs. Selling costs are rising with more employees. We will agree that cash G&A costs should leverage but are only 12% of sales. NET can't reach its target if G&A went to zero. We still believe NET will need stock compensation to rise as a percentage of sales.

The Coca-Cola Company (KO)

Date Added	3/30/2022
Market Cap	$258.8 B
PE (fwd)	23.0
Short %	0.45%
Current EQ Rating	3- (Minor Concern)

KO's adjusted 1Q23 EPS of $0.68 beat forecasts by 3 cents. We see several items that can fully account for the 3 cents plus we see growing pressure from higher inventories, higher advertising & promotion, with less pricing power:

- Bad debt reserves fell to $512 million from $516 million in December on a 28% increase in gross receivables. That added as much as $148 million to earnings or 2.7 cents per share. Some of this is seasonal as receivables tend to rise in 1Q vs 4Q.

- We still see the excessive pricing taken in Latin America as unsustainable. The difference between Pricing and FX should be a single-digit spread. It dropped to 13% from 19% in 4Q22. But if it's still 5%-7% too high, this added 1.1-1.6 cents to EPS:

Latin America	**1Q23**	**4Q22**	**3Q22**	**2Q22**	**1Q22**	**4Q21**	**3Q21**	**2Q21**	**1Q21**
Volume Growth	1%	6%	6%	-4%	20%	-10%	11%	29%	2%
Pricing Growth	18%	26%	12%	12%	19%	11%	23%	9%	7%
FX	-5%	-7%	-6%	-1%	-6%	1%	7%	3%	-10%

- Stock compensation was down $29 million – adding 0.5 cents.

- Depreciation was down again and we estimate that added 0.5 cents. This is already helping gross margin and capital spending looks light over several years.

- Rounding EPS to two digits added 0.4 cents.

- KO boosted inventory in 4Q by 10 days to more normalized levels. It appears that in 1Q23 inventory has jumped above normal levels. This is important because KO continues to see price increases moderating going forward and expects to see more promotional spending that further lowers pricing. Gross margins are not back to pre-Covid and the new inventory likely cost more given inflation. With Average-Cost and FIFO inventory

methods at KO, it should be selling higher-cost inventories as pricing pressure builds. We believe all of that may lower margins going forward:

	1Q23	1Q22	1Q21	1Q20	1Q19
Inventory	$4,727	$3,741	$3,356	$3,558	$3,178
Adj. COGS	$4,282	$4,233	$3,556	$3,291	$3,012
DSIs	99.4	80.4	86.8	94.1	92.9
Gross Margin	60.9%	59.7%	60.6%	61.6%	62.5%
Pricing	11%	7%	1%	0%	5%
FX	-6%	-4%	-1%	-2%	-6%

- Advertising rose y/y by $85 million to $1.065 billion. As a percentage of sales, it was 9.7% vs. 9.3% which cost KO 0.7 cents in EPS. The company is guiding to more spending in this area and this could remain a headwind.

- KO still expects the IRS will rule against it on KO's allocation of foreign earnings. It issues all its guidance saying this item is not part of its cash flow forecasts. To appeal a decision, KO's estimate is that it will need to post $5.2 billion in cash. We will still point out that Free Cash Flow is expected to be $9.5 billion and there's an $8.0 billion run rate on the dividend. Plus, KO normally repurchases shares to help EPS growth. We do not think the dividend is at risk, but repurchases may decline and hurt EPS growth in 2023.

Dentsply-Sirona Inc. (XRAY)

Date Added	4/10/2023
Market Cap	$8.7 B
PE (fwd)	21.1
Short %	2.9%
Current EQ Rating	2- (Weak)

XRAY's adjusted 1Q23 EPS of $0.39 beat forecasts by 5 cents but fell y/y from $0.54 in the year-ago quarter. The low-end of 2023 guidance was raised by $50 million for sales and 5 cents for adjusted EPS. There were fewer earnings levers used this quarter but still several areas of concern. Plus, XRAY simply does not grow. Guidance calls for sales to trail levels seen before the companies merged despite multiple price hikes and a supposedly inherently growing market:

- The 5-cent beat was helped by low expectations. XRAY also admitted it pulled $20 million in consumable sales forward – that was worth 2.5 cents with a price hike adding more to EPS and XRAY lowered its share count for 1.8 cents.

- 1Q21 saw XRAY offer incentives to distributors to buy more and helped grow sales $10 million. That didn't recur in 1Q22 giving XRAY an easy sales comp. Yet sales were only up $9 million with $20 million of sales pulled from 2Q.

Inventory is now 140 days and XRAY sees delays in ordering for tech equipment, hurt by rising interest rates making too expensive for many dentists to justify financing. 140 days is near record territory for XRAY and it already pulled some 2Q sales into 1Q. This is a company that has had several blow-ups from stuffing the channel in the past.

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

- The problem is XRAY sees a large pricing weakness in China now. It wants to cut SKUs from inventory. And its distributor customers also already have high inventories too. HSIC already added CAM/CAD equipment to its inventory:

HSIC	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Inventory	$1918	$1963	$1,818	$1,823	$1,871	$1,861	$1,784	$1,688	$1,626
DSI	83	81	77	80	77	72	72	74	73

PDCO	Jan 23	Oct 22	Jul22	Apr22	Jan22	Oct21	Jul21	Apr21
Inventory	$939	$877	$875	$786	$869	$830	$770	$737
DSI	68	62	66	55	63	57	56	53

- Inventory reserve rose to $90 million up $7 million from 4Q22 – a 2.4-cent headwind for EPS.

- The effective tax rate was 25.8% vs. guidance of 22%-23% in 1Q – hurting EPS by 1.4-1.9 cents. A sequential drop in bad debt reserves offset this.

- Why doesn't this growth story show growth?

	1Q23	1Q22	1Q21	1Q20	1Q19	1Q18
Sales	$978	$969	$1,027	$874	$946	$956
Y/Y Change	0.9%	-5.6%	17.5%	-7.6%	-1.0%	6.2%
Org./Internal Chg.	5.1%	-1.4%	12.1%	-4.3%	3.9%	-1.1%

We understand the Covid collapse in 2020 and the rebound of dentists working overtime in 2021. But this company has taken four price hikes since 4Q21. In 2020, it left precious metal appreciation in organic sales – there's another price hike. Population growth is supposed to drive sales along with aging. Taking $20 million of channel stuffing out of 1Q23 – sales are the same as in 2018 and 2019 and 2022.

- For the first time in a while, we did not have a problem with spending levels for stock compensation, R&D, or depreciation. All were at or near normal levels.

International Business Machines Corporation (IBM)

Date Added	3/12/2021
Market Cap	$120.6 B
PE (fwd)	14.2
Short %	2.9%
Current EQ Rating	2- (Weak)

We continue to see IBM as a company that pulls many levers every quarter to generate enough short-lived EPS to beat forecasts. After beating 1Q23 by 12 cents, IBM cut revenue forecasts and announced the year would be back-loaded.

- Depreciation came in at $527 million vs. $631 million y/y IBM reported that the longer assumptions for depreciation lives added 6 cents So, non-GAAP EPS was helped by 3.9 cents in this area, beyond guidance.

- IBM cut advertising from $336 million to $314 million – adding 2.1 cents to EPS.

- IBM's bad debt expense fell from $16 million to $2 million – adding 1.3 cents.

- It reversed $17 million out of standard warranty accruals in 1Q23 – adding 1.6 cents.

- The deferral for new extended warranties fell by $9 million y/y – adding 0.9 cents.

- IBM guided to a 1Q charge of $300 million, it only took a charge of $260 million, adding $40 million to pretax income from guidance. This was 3.8 cents for the 1Q23.

- **R&D dropped again in absolute dollars and as a percentage of sales revenues (removing the financing and other revenues). This added 2.3-4.1 cents to 1Q23.** Why aren't wages rising? If they are, IBM is spending less on projects. Plus, IBM continues to buy other companies – aren't there some R&D departments being rolled into IBM? How can the total spending continue to decline?

- The tax rate was 13.8% down from 16.1% y/y. The problem is IBM guided to mid-high teens for taxes. That sounds like 16%-18% to us. That added 3.5 cents at 16% or 6.7 cents at 18%. IBM kept guidance flat for the tax rate for 2023.

- **Other income rose to $242 million from $179 million.** IBM guided for this income source to decline significantly in 2023 on 4Q earnings call – specifically because it thought gains on FX derivatives would not be as strong. That was the case as FX was a -$264 million swing. However, this was almost entirely offset by y/y gains in other derivatives of $244 million. These appear to be largely reclassified gains on FX from Accumulated Other Income. The rest of the increase was fueled by interest income rising. We expected that, but not the $244 million in reclassified gains. **We are sticking with our estimate that this was a 10-cent tailwind for EPS** as the guide was for this to be down.

- SG&A was down too. We subtracted all the parts already counted above such as bad debt expense, advertising, the $260 million charge, stock compensation, and workforce rebalancing below. We also pulled out some derivative gains/losses. SG&A in dollar terms fell by $172 million to $3.56 billion. In dollar terms, it added 16.3 cents. As a percentage of operating revenues (not financing income), it was down $280 million or 27 cents. We believe IBM is giving wage increases to many employees, and at least 10-15 cents of this is not sustainable.

- Stock compensation was up $34 million, which hurt EPS by 3.2 cents.

- Workforce Rebalancing came in at $259 million vs. our estimate of $250 million. Against 1Q22's $5 million, IBM had a $254 million headwind or 24.1 cents. After ignoring this line item in SG&A following a big-bath charge in 4Q20 allowing IBM to book far-below-normal expense in this area and even credits to drive EPS in 2021 and 2022 – IBM made sure to point out that this $259 million was a big headwind. In reality, $259 million was not that far out of the ordinary. It is guiding to more of this rebalancing coming for 2Q.

- **IBM will also change its earnings presentation to remove the workforce rebalancing charges.** These are ongoing cost items that occur every year and nearly every quarter. After having it drive EPS when it was materially lower – IBM is now going to report that its segment profits are higher:

> *"**We are no longer including workforce rebalancing charges in our measure of segment profit to provide a view of our segment results** consistent with our ongoing operational profile."*

- We wondered how the new Z-System roll-out would mature – now we see a large drop against two easy comps. 1Q23 was the last easy comp and Z-Systems only posted a 7% growth rate y/y.

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%

The bold figures are Z-systems growth, the non-bold figures are the full systems unit's growth rate and Z-systems are were called as leading the full unit.

Iron Mountain Incorporated (IRM)

Date Added	12/4/2020
Market Cap	$17.3 B
P/FFO (fwd)	19.9
Short %	4.8%
Current EQ Rating	1- (Strong Concern)

IRM's results continue to show similar levers being pulled. In 1Q23, FFO of $0.71 beat by 3 cents but was down 3 cents sequentially and up 5 cents y/y. AFFO of $0.97 was down 1 cent sequentially and up 6 cents y/y.

- Spending less on maintenance capital expenditures added 3.0 cents sequentially and 2.4 cents y/y to AFFO.

- Ignoring principal payments on financing leases was 4.0 cents for both FFO and AFFO and were cash payments.

- Stock compensation is a recurring item. At $12.5 million it added 4.3 cents to both FFO and AFFO.

- Derivative amortization was not adjusted for until 4Q22 – that was $5.8 million or 2.0 cents for both FFO and AFFO.

- Cash inducement costs were $25.4 million in 1Q up from $16.2 million – AFFO ignores this and FFO only recognizes what is amortized. For AFFO this added back 8.7 cents vs. 5.5 cents the year before.

Just that gets AFFO down from 97 cents to 75 cents. IRM would argue that still amply covers its dividend of 61.85 cents. The problem is IRM also relies on acquisitions, heavy capital spending overall, and restructuring costs consume cash. That's why AFFO does not cover the dividend when all the cash needs are examined:

IRM	1Q23	1Q22
CFO	$129	$55
CapX	$266	$161
Acq.	$1	$718
Fulfillment	$25	$16
JVs	$16	$0
Sale PPE	-$36	-$5
Free Cash	-$144	-$835

- We have also pointed out that Service revenue (collecting, returning, destroying documents) plummeted during Covid and then bounced back up. It has now declined for four straight quarters:

Service	4Q	3Q	2Q	1Q
2023				$504
2022	$510	$527	$536	$497
2021	$434	$412	$402	$374
2020	$362	$340	$305	$385
2019	$404	$389	$398	$391

IRM will blame the decay on FX losses. We noticed that pricing is down for service revenue offset by a small amount of volume growth. Total organic growth was only 2%.

- At the same time, IRM looks VERY dependent on boosting prices for storage. In the 1Q, volume was up only 0.3% with pricing up 10.8%. If service cannot boost price, will the storage revenue growth hold? Every 100bp lost in pricing would cost IRM 2.6 cents in quarterly AFFO.

- Debt continues to rise here too. It was $9.3 billion in December 2021, now it's $11.0 billion. That's 5.9x adjusted EBITDA and the lease obligations have grown too.

- The risk to us remains that IRM has a growth multiple of 15.2x EBITDA and it other than price increases of late has very little growth. With debt at almost 6x EBITDA – valuing this at 12x cuts $20 off the stock.

Keurig Dr. Pepper Inc. (KDP)

Date Added	12/4/2020
Market Cap	$43.9 B
PE (fwd)	17.6
Short %	0.83%
Current EQ Rating	2- (Weak)

KDP's 1Q23 adjusted EPS of $0.34 beat forecasts by 1 cent. Guidance was not raised and multiple items helped the earnings beat that may not be sustainable:

- KDP is guiding to a 22% tax rate and just reported a 19.9% tax rate which added 0.9 cents plus rounding up results added another 0.2 cents.

- KDP has rolled all its foreign operations into one unit, so we cannot isolate Latin American FX – but it did report a 0.5% positive FX impact in the quarter. Last quarter, FX was -6.5% for Latin America. The 7.0% swing should be worth about 0.6 cents in EPS. We consider Latin American FX to be one of the bigger short-term gimmicks we have seen for several companies. Historically, the negative FX hit is larger than the sizeable pricing gains. There has been a short period after violent swings where companies have taken big pricing gains, and seen modest to even positive FX issues from Latin America. That has not been the case with Asia or Europe and we would expect Latin America to normalize.

- Principal payments on financing leases rose to $24 million from $20 million. This is ignored in EPS entirely but helped by 1.4 cents in 1Q23 vs. 1.1 cents in 1Q22.

- As noted last quarter, KDP continues to add back charges related to productivity and restructuring that are more than 10% of earnings. In 1Q23, this was another 4 cents for productivity. Shouldn't these charges get smaller after years of these actions?

- After all the pricing gains and productivity and restructuring programs – it is concerning that gross margins and operating margins are flat to declining. Coca-Cola is forecasting pricing gains to weaken and promotional spending to rise. KDP came into 2023 saying it expected higher marketing too – we only see a mention of that for the US Beverage unit

so that headwind could build more. Marketing and R&D were down from 2019 to 2022 by $149 million – representing as much as 8 cents of EPS that could be lost:

	1Q23	1Q22	1Q21	1Q20	1Q19
Pricing	9.9%	6.3%	0.5%	-0.5%	1.1%
Volume	-1.0%	-0.2%	10.3%	5.0%	1.4%
Gross Margin	52.7%	52.7%	55.5%	56.8%	56.7%
Operating Margin	20.8%	23.8%	25.5%	26.2%	24.8%

- Total lease cost continues to rise as a result of KDP's sale-leasebacks. This is supposed to lower depreciation as an offset, but this is a headwind. Total lease cost was $77 million vs $65 million last year while depreciation rose $1 million too. This was a 0.7-cent headwind.

- Stock compensation was a headwind in 1Q23. Last year, KDP had a credit vs. an expense this year. The y/y adjusted swing was $34 million or 1.9 cents of headwind.

- **Payables have reached 281 days up from 268 days in 4Q.** KDP has factoring set up for suppliers to sell their KDP debt and collect cash more quickly. Suppliers have sold $3.9 billion or 222 days of KDP's payables. There is still no comment concerning the rising cost of doing this to the suppliers, but this isn't free anymore. It should be costing suppliers 5%-6% in interest expense. We still believe this is debt that KDP may be forced to deal with on short notice. KDP does not have $3.9 billion in available cash, only $204 million, and its credit line that will cost it more interest expense.

- **Total debt continues to be misleading. KDP only looks at bank and bond debt less cash.** We believe the factored payables of $3.9 billion should be included as well as structured payables (a corporate credit card) of $137 million, and the PV of finance leases of $915 million should be viewed as debt too. KDP has its debt at $12.2 billion and 3.0x trailing EBITDA. We think it is nearly $5 billion higher and 4.25x trailing EBITDA.

- It is worth noting that coffee has seen -6.6% volume decay in 1Q with pods down 1.9% and brewers down 9.8%. Pricing is not that strong for coffee either at 5.5%. The 12.5% pricing gain for US Beverages looked high and KDP seems to be relying on large pricing continuing for that unit. Every 100bp of pricing that doesn't hold at that unit is 1-cent of EPS headwind per quarter.

Mohawk Industries, Inc. (MHK)

Date Added	9/27/2022
Market Cap	$7.2 B
PE (fwd)	9.4
Short %	2.6%
Current EQ Rating	2- (Weak)

MHK's 1Q 23, beat EPS targets by 46 cps. This was driven by sales coming in over $65 million ahead of consensus, which management attributed to better-than-expected pricing/mix. However, we believe another increase in DSOs could have been a significant contributor to the revenue surprise in addition to other benefits.

- DSOs rose by 5 days YOY and 2 days sequentially. This could have been partially influenced by acquisitions closed during the quarter but we believe that was likely one day of sales impact. This is the second straight quarter of DSO increased even though both quarters saw declining revenue and customers trimming their inventories. Management adds Trade, Other, and Tax Receivables together to report DSOs improved slightly. Pulling out the tax receivables shows the growth:

	4/1/2023	12/31/2022	10/01/2022	7/2/2022	4/2/2022	12/31/2021	10/2/2021
Revenue	$2,806.2	$2,650.7	$2,917.5	$3,153.2	$3,015.7	$2,760.7	$2,817.0
Gross Customer Trade Receivables	$1,919.5	$1,699.1	$1,899.5	$2,003.4	$1,947.0	$1,721.6	$1,820.8
Allowance for Discs. Claims, & Doubtful Acct	$81.8	$73.8	$71.7	$73.7	$73.2	$73.1	$78.2
Net Customer Trade Receivables	$1,837.6	$1,625.4	$1,827.7	$1,929.7	$1,873.8	$1,648.4	$1,742.5
Trade Receivables DSOs	59.6	55.8	57.0	55.7	57.2	53.7	56.3
Other Receivables	$190.9	$219.4	$148.3	$132.8	$111.5	$117.8	$108.5
Other Receivables Days of Sales	6.2	7.5	4.6	3.8	3.4	3.8	3.5
Trade and Other Receivables DSOs	65.8	63.3	61.6	59.5	60.6	57.6	59.8

- The company has prominently noted that its customers have been cutting their inventories in preparation for a slowdown which is consistent with what we are hearing from the big box retailers. Two straight quarters of slowing sales and rising DSOs when customers are trimming stock is a concern. The bulk of the company's earnings surprise came from sales coming in about $60 million higher than Wall Street was expecting. One day of sales amounts to about $31 million in revenue which implies the DSO increase could have been responsible for much of the upside.

- Despite the increase in average capitalized contract costs, the related amortization expense fell by $4 million sequentially, 3.5% on a percentage basis YOY, and 6.6% on a percentage basis sequentially. To put this in perspective, if the amortization expense percentage had been in the more normal 25% range, it would have shaved over 3 cps off of EPS growth in the quarter. We expect this to return to a more normal range over the year which could be a mild headwind to earnings growth.

	4/1/2023	12/31/2022	10/01/2022	7/2/2022
Ending Balance Capitalized Contracts	$63.082	$59.015	$60.457	$58.451
Average Capitalized Balance During the Quarter	$61.049	$59.736	$59.454	$53.747
Amortization of Costs to Obtain Contracts	$13.099	$17.126	$13.518	$12.536
Amortization % of Average Capitalized Balance	21.5%	28.7%	22.7%	23.3%

	4/2/2022	12/31/2021	10/2/2021	7/3/2021
Ending Balance Capitalized Contracts	$49.042	$49.644	$57.065	$58.012
Average Capitalized Balance During the Quarter	$49.343	$53.355	$57.539	$56.278
Amortization of Costs to Obtain Contracts	$12.340	$17.639	$13.846	$14.615
Amortization % of Average Capitalized Balance	25.0%	33.1%	24.1%	26.0%

- The company added back 40 cps in restructuring costs. While the company occasionally has quarters without huge charges, charges amounting to at least 15% of earnings are typical for MHK which greatly reduces the quality of adjusted results in our opinion.

Post Holdings, Inc. (POST)

Date Added	3/30/2022
Market Cap	$5.5 B
PE (fwd)	20.8
Short %	4.9%
Current EQ Rating	3- (Minor Concern)

- POST beat forecasts by 29 cents in 2Q23 (March) and by 46 cents in 1Q23 (December). By boosting prices more than inflation warranted – POST picked up 77 cents for March and 85 cents in December. The bulk of the pricing was due to eggs. The problem we see is eggs dropped from $5/dozen in December to 56 cents in May. We have a tough time seeing POST holding all the price increases it has taken especially since it is seeing customers trade down to more private-label goods. Higher freight costs are already vanished and are now falling.

	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
Pricing	$229.8	$231.2	$234.8	$190.7	$85.1	$89.5
Raw Materials	$160.4	$142.7	$111.7	$123.7	$51.6	$46.5
Manufacturing	$23.1	$14.4	$20.6	$27.1	$23.7	$23.4
Freight	-$21.0	$0.0	$19.5	$27.4	$34.0	$27.7
Net Pricing	$67.3	$74.1	$83.0	$12.5	-$24.2	-$8.1

- POST was still cutting advertising in 1Q23, while competitors boost their spending. This added over 3 cents to 1Q23 EPS. It was not quantified for 2Q23, but POST said it was starting to raise its advertising too. We expect this to be a headwind.

- POST stopped accounting for additional equity losses from the 8th Ave spin-off. POST still owns 60.5% of the common, but there is a PIK preferred stock above it that continues to dilute POST and cause losses for the common stock. POST already wrote the stock to zero. The size of the loss is 28 cents in both 1Q23 and 2Q23.

- Depreciation and amortization declining y/y added 1.3 cents to 2Q23 and 4.4 cents for 1Q23.

- Inventory still looks too low – it should be in the mid-50s:

Inv. DSI	4Q	3Q	2Q	1Q
2023			44.4	47.6
2022	42.6	41.1	45.2	46.9
2021	42.8	55.1	56.5	53.2
2020	56.3	61.8	49.2	54.5
2019	53.4	52.4	54.1	46.2

This would cost about $140 million in cash flow. Also, with FIFO accounting, we would expect a gross margin headwind as POST sells off higher-cost inventory with less pricing power. The y/y trend looked much less favorable already in 2Q23. 50bp of gross margin is worth about 9 cents in EPS.

	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Gross Margin	25.5%	26.5%	24.9%	23.9%	26.8%	25.1%	24.5%	29.5%	30.4%

- The SPAC has been unwound without doing a deal. That removes some potential to get investors excited – even though we have not seen much to get excited about on any POST deals except for BellRing over the years.

- POST closed on its 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%. These assets had taken big pricing hikes during early 2022 – we doubt that will last either.

On Deck Risks

Becton, Dickinson and Company (BDX)

BDX beat the consensus adjusted EPS target for the 3/23 quarter by 10 cps. The company raised the mid-point of its guidance for the full year ended 9/23 by 1.5 cps. This included an increase in the estimated negative FX impact of 5 cps and an increase in the expected impact of lost Covid test income of 5 cps. This implies an increase in the estimated performance of the base business of 11.5 cps. However, about 5 cps of that came from the company cutting the midpoint of its estimated tax rate for the full year by 40 bps. The company admitted that the second quarter rate was lower than it anticipated due to the timing of discrete factors.

- In our review of the 12/22 quarter, we warned that the company's accounts receivable adjusted for factored receivables that remained outstanding jumped materially versus sales both YOY and sequentially. We also noted that the pace of factoring increased in the 9/22 quarter.

- In the 3/23 quarter, DSOs adjusted for factored receivables that remained outstanding jumped to 51.7 in the 3/23 quarter which was 3.6 days above the year-ago quarter. However, DSO declined sequentially by 0.4 so the pace of the increase has slowed and reduced concern that the company pulled sales into the 3/23 quarter at the expense of the next.

- However, the pace of factoring remained high as factored but outstanding days jumped to 6.7 vs 6.3 in the previous quarter and 4.5 a year ago. Cash from operations has received a $400-$600 million YOY boost from the expansion of factoring over the last three quarters. Absent a huge acceleration in factoring which is unlikely given the rise in interest rates, the cash flow tailwind will be gone after the 6/23 quarter.

- Inventory was essentially flat sequentially which brought DSI down by 10.5 days. This is in line with the company's narrative that it is working down inventory which contains higher cost layers. Management noted on the call that it carries about 5 months of inventory so the second half should benefit once these higher cost layers have burned off.

- Prepaid expenses declined sequentially by $100 million in the quarter. While still elevated, our concern that earnings artificially benefitted in the quarter by increased capitalization is reduced.

- We again note that we believe the company’s practice of adding back amortization of intangibles to non-GAAP results paints an unrealistic picture of earnings given that tuck-in acquisitions are a key part of its growth strategy which means it is essentially acquiring much of its R&D.

Cintas Corp (CTAS)

CTAS reported its fiscal fourth quarter yesterday, topping the consensus estimates by 14 cps. However, the company forecasted for FY24 EPS to come in between $13.85 and $14.35, with a midpoint of 14.10. This was below the consensus estimate of $14.29. The stock has essentially traded flat since then.

We need to 10-K to review the accounting. Key areas of interest will be the inventory reserve and components of other assets.

Okta Inc (OKTA)

OKTA has changed its definition of adjusted earnings three times in the last three quarters. It is cheering its non-GAAP results turning positive and beating forecasts, but we still see a company that relies on paying employees more than 30% of sales in stock compensation that it adds back to adjusted results. Even DOCU and NET target less than 20%. OKTA beat last quarter by 10 cents:

- Adjusted R&D (excluding stock compensation) dropped 500bp y/y and added 8 cents to adjusted EPS. We can see headcount is up, wages are rising for most employees. This does not look sustainable to us and has been a to OKTA results for the last three quarters. Also, these R&D employees are not getting more stock pay either.

- OKTA reported it cut marketing by $13 million in 1Q24, which added 5.5 cents to adjusted EPS. Its total adjusted Sales and Marketing spending was flat sequentially and up only $5 million y/y. Yet it is telling investors it expects to ramp up spending in this area. Again, headcount is higher – none of this looks sustainable.

- Capitalizing new commissions and amortizing new accounts over 5 years and renewals over 2 years normally is a big driver of earnings for OKTA. That spread of new capitalization vs. amortization has narrowed to where it only provided 1 cent of EPS in 1Q24. It points to fewer new accounts in our view and more renewals where the amortization is faster. OKTA is telling investors that it has a longer closing cycle and potential customers are asking for shorter contracts. If new commissions fall below amortization – this could become a headwind for EPS.

- OKTA is a high-tech software company, yet capital spending is normally only about $2-$5 million per quarter. It just posted a $0 for the last quarter. Net PP&E has declined over the last year.

Top Values

Air Lease Corporation (AL)

Date Added	9/27/2022
Market Cap	$4.8 B
PE (fwd)	8.9
Short %	1.82%
Current EQ Rating	4+ (Acceptable)

Air Lease's 1Q23 adjusted EPS of $1.50 handily beat forecasts by 30 cents. We still view believe AL should trade at or above its book value of $53 as we believe the book value is understated. Several items still impacted EPS:

- Transitioning planes results in the recognition of security deposits and maintenance reserves. In 1Q23, this was $34.6 million to transition 11 planes to new leases. 1Q22, this was $59.6 million as AL recognized these items for the Russian planes that were nationalized. In adjusted EPS, this was a 22-cent headwind for AL.

- SG&A continues to be elevated with higher insurance premiums of $4 million or 4 cents per share. SG&A also saw $6 million of expense related to airline restructurings that resulted in the transitioning of the planes to new leases described above or 5 cents.

- Deferred rent from Covid is no longer being quantified, but AL says customers are paying on time. It is likely this source of revenue was lower y/y simply due to less of it being outstanding. At the end of 4Q, this was $148 million and was likely down about $5-$6 million y/y in what was received in 1Q23 for a headwind of about 5 cents. As this deferred rent is repaid, this source of revenue will vanish.

- Gain on aircraft sales is a lumpy item and rose from $4.4 million to $8.8 million y/y for 1Q23, giving AL 4 cents in EPS. Guidance is for aircraft sales to be higher in 2023 with another $1-$2 billion of sales later this year.

- Share count was down by 2 million and helped EPS by 4 cents.

- Overall in the quarter, results are moving in the right direction. EPS fell y/y from $1.76 to $1.50, but much of that was due to losing the Russian planes last year. The security deposit income from those planes recognized last year was over 50 cents.

- AL is trading for $37-$38 vs. reported book value of $53.

- Potential insurance payments on the Russian planes still represent over $5 in book value that could return.

- There should still be about $1 in book value from the repayment of deferred rent that has not shown up yet.

- The values for new and young planes are rising. Demand is high and there is a shortage of new planes from Boeing and Airbus. AL is booking gains on sales. Every 1% change in the value of its depreciated planes is worth about $2 in book value.

- AL also has early delivery slots for new planes. Everyone's plane orders are delayed, but airlines ordering planes for 2028 that may arrive in 2033 may be willing to pay AL to trade delivery positions on some planes.

- The bulk of AL's interest cost is fixed as are existing leases. So that spread is locked in. As leases roll over, the price can rise for the new lease. Also, new delivery contracts have lease escalation clauses that boost the lease cost until the plane is actually delivered. AL's revenue is growing also with 88% fixed rate debt, its cost of funding there is up only 22bp in the last year.

- The market also overlooks the spread – AL is a BBB credit and many of its customers are B-rated. Also, new BBB credit activity is 5.90% now. But AL's cost of fixed-rate debt is only 3.20%. That is boosting the spread too.

- Only about 12% of debt rolls over in any given year, which matches the 7-10 year maturity cycle for plane leases. We believe AL will maintain its spread. Even management notes that AL's history is doing 10-year deals with assets that have 25-year lives. They realize that during those longer periods, there will be multiple swings in oil prices, economies, interest rates, etc.

- When credit is tighter, it should further help AL by leading more airlines to lease rather than buy planes. That increases the size of AL’s market.

Air Products (APD)

Date Added	4/10/2023
Market Cap	$65.4 B
PE (fwd)	25.7
Short %	0.83%
Current EQ Rating	4- (Acceptable)

APD's 1Q23's $2.64 in adjusted EPS missed forecasts by 6 cents. There were some areas that helped EPS too. The market seemed more upset over guidance of $2.50-$2.70 for 2Q23 and some changes in the structure of a project and rising interest rates.

- 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 known. However, this change actually reduced pension expense y/y from $11 million to $6.3 million adding 1.7 cents to non-GAAP EPS that likely was not expected.

- Taxes were a 7-cent headwind rising to 19.1% from 17.0%, but APD guided to 19%-20%.

- 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:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
FX Impact on Sales	-6%	-6%	-5%	-2%	-1%	2%	6%	4%	3%

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

- The concerns for the change in the NEOM plant structure look overblown by the market. This was expected to cost $5.0 billion and there is news that it will cost $8.5 billion and will cut the ROI because the output will remain flat and at the same price. That's overly simplistic. The change in price on the original design is only $500 million due to inflation. Here is where the other $3.0 billion goes:

    - NEOM will now spend $1.2 billion more to add its own power transmission and additional infrastructure to make the plant fully self-sufficient and that lowers operating costs.

    - Originally, the project was going to lease the land. Now $300 million will go toward purchasing the land and locking that in at a lower cost.

    - Another $200 million will purchase spare/replacement parts at the same time as construction. This will reduce future maintenance costs and again lock in some of that operating cost.

    - Total debt will rise from $3.3 billion to $6.2 billion on the project. That will also boost capitalized interested during construction which now comes in at $1.0 billion.

    - Rather than be owned by APD for $1.7 billion in cash with $3.3 billion in debt. It will be a stand-alone JV with more debt to boost ROE. APD will put up $800 million of cash and free up the remaining funds it expected to spend on other projects.

- The ownership of NEOM will show up in equity affiliates income for APD at a smaller ownership stake. The initial thoughts were for a 12% ROI for APD on $1.7 billion. That included selling all of the output from the plant. APD still gets to sell 100% of the output even though it will own 35% of the project and the cost it will pay for the output remains the same as before.

    - APD still expects to generate a 10% operating margin on the sale of the output. That return will be on a 65% smaller investment, which should boost ROI.

    - The equity investment will benefit on ROI from having no lease expense for the land, lower power costs, and having prepaid some maintenance – offset by higher depreciation for capitalized interest and $0.5 billion of inflation.

Costco Wholesale Corporation (COST)

Date Added	12/2/2022
Market Cap	$238.6 B
PE (fwd)	36.9
Short %	0.87%
Current EQ Rating	5+ (Strong)

COST does not report adjusted EPS and in their 3Q23 (ending May 7), their $2.93 missed forecasts by 50 cents. However, it discontinued its private shipping charters that it set up when the supply chain was stretched to ensure it could get goods to its stores. Ending those charters now that deliveries and shipment times have normalized cost $298 million or 50 cents, meaning without that, COST hit forecasts. Without that charge, net income rose 8% y/y.

- COST guided to a 26%-27% tax rate and came in at 26.5% vs last year of 24.9% which hurt EPS by 6 cents.

- Deflation for food and gasoline are hurting sales – but gross profit in dollars and margins rose. Sales were up 1.9% in dollar terms, with gross profit up 6.3% and margin up 13bp. There was no LIFO charge in 3Q23 which we expected to be the case. Lower inventory costs are also driving cash flow up as cash is released from working capital.

- COST continues to be hurt on tough comps for big-ticket items like electronics, home furnishings, and jewelry which have faced strong comps from Covid and the early quarters following Covid. We have seen the same from several other companies such as Texas Instruments. The headwinds are pronounced down 17%-20%, but they have an outsized impact on e-commerce where they are 55% of sales.

- Earnings quality remains high in our view. The issue that is moving the stock more is the rate of growth in a couple of areas: getting big ticket items to rise and the rate of growth in membership fees as those are essentially 100% margin. On the membership fees, COST has continued to see record-high renewal rates and customers still moving to higher-end programs. It has not raised base fees in some time, and we still see that as possible in the future that could drive EPS growth higher.

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
Big Ticket Comps	-17%	-11%	-HSD	+ slight	+ MSD	+HSD
Membership fee Growth	6%	6%	6%	8%	9%	10%
Paid Members	69,100	68,100	66,900	65,800	64,400	63,400
Total Card holders	124,700	123,000	120,900	118,900	116,600	114,800

The comps get easier on big-ticket items going forward. Jewelry and home furnishings were among the stronger categories in 2021 and early 2022 along with electronics. Membership figures are still rising even with some deflation in food. A $5 increase in fees per year is worth about $1 in EPS.

LyondellBasell Industries N.V. (LYB)

Date Added	7/14/2021
Market Cap	$30.2 B
PE (fwd)	10.1
Short %	1.96%
Current EQ Rating	5+ (Strong)

We still consider LYB a cheap stock with a decided cost edge over its foreign competitors. With the new plant online now and its continued focus on several small cost reductions and bottleneck cures (something LYB has done for years) it sees the mid-cycle EBITDA could reach $10 billion. The company has repurchased 45% of its stock, its 5.3% dividend grows at 5% plus the occasional special dividend, and yet it sells for 4x normalized EBITDA and 7.5x trailing twelve months EBITDA due to concerns over clearly temporary problems including plants being shut down for maintenance and energy cost spiking in Europe.

- 2023 is a heavy year for plant maintenance and LYB opted to pull even more maintenance plans forward into 2Q23 which will impact EBITDA by an additional $90 million this quarter.

- It still plans to close the refinery by the end of 2023. That action is expected to cut EBITDA by $75 million each quarter of the year ($69 million in 1Q23). Cleaning up and decommissioning the refinery is expected to cost $600-$900 million, but it should also result in the release of about $700 million of working capital. The bigger short-term concern is the refinery has been enjoying some of the highest spreads in its history at the moment so it is generating solid EBITDA. That has not always been the case as many years the refinery lost money or had very modest results. That is part of the reason why LYB saw the level of investment needed for the plant vs. its history as a reason to close it. It believes that after weaker markets in China for several quarters, getting past the energy issues in Europe, and all the maintenance, normal production can offset the loss of the refinery going forward.

- Inventories are back in line with historical figures at 52 days. That is up from recent quarters in the mid-40 days range. With commodity costs down, this did not consume the $1 billion we had expected and came in at less than half that amount.

- With the large PO/TBA plant online, capital spending should drop in 2023 to $1.6 billion vs almost $2 billion in the prior three years. Maintenance capital spending is about $1.1

billion, so between that and the dividend of $1.6 billion, cash needs are still half the EBITDA LYB produced the last twelve months with several macro issues and maintenance programs impacting production and results.

- The $750 million in minor cost reductions and fixes within operating bottlenecks is about $1.50-$2.00 in EPS. That should arrive in lumpy amounts, but it gives a good tailwind along with share repurchases for EPS growth.

Philip Morris International Inc. (PM)

Date Added	4/10/2023
Market Cap	$153.7 B
PE (fwd)	15.9
Short %	0.33%
Current EQ Rating	4+ (Acceptable)

The primary reasons we like PM are the potential to roll out heated tobacco/IQOS in the US market during 2024 and the acquisition of Swedish Match. Both situations help PM's lack of US dollar revenues while servicing debt and dividends in dollars. Also, both could allow PM to attack the US cigarette market with impunity as it does not have a cigarette market share to protect. Heated tobacco has a history of cannibalizing the traditional smoking market rapidly and with high prices in the US – PM believes it can pull 10% of the $20 billion in profits within 6 years.

- 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.

- PM's adjusted EPS of $1.38 beat forecasts by 4 cents. We do not consider this a quality beat.

- PM guided to a 20.5%-21.5% effective income tax rate and came in at 17.3% - that added nearly 5 cents.

- Equity Investment income looks high at $51 million and was 3.3 cents by itself. With a large Russian investment, the dividends dropped significantly in 2022. The equity method accounting would boost income if the dividend is smaller.

- Pension costs were an $18 million headwind for 1 cent.

- PM reduced guidance due to heavier expected FX losses. Expected 2023 EPS of $6.25-$6.37 with 15 cents of FX headwind is now $6.10-$6.22 with 30 cents of FX.

1Q results and 2Q results are being impacted by the rollout of more ILUMA product that will replace some of the earlier IQOS product. The inventory for ILUMA is building and PM wants to

keep lower inventory levels of IQOS in some markets to lessen the risk of write-downs for IQOS product later. That is pressuring some of sales. Guidance is for sales growth and ILUMA to build through the year

Starwood Property Trust, Inc. (STWD)

Date Added	2/8/2022
Market Cap	$6.3 B
PE (fwd)	10.4
Short %	7.0%
Current EQ Rating	5+ (Strong)

STWD's 1Q23 distributable earnings (DE) of 49 cents missed forecasts by 1 cent. This remains a misunderstood stock in our view as it trades at a discount to book value and a yield of 9.6%. Some headwinds for earnings are self-imposed as STWD hoards liquidity to take advantage of markets turning.

- The market views STWD primarily as a financing agent for US commercial office space. That simply isn't true as US office space is only 10% of their total lending base. STWD also has few NYC loans (about 2% of commercial lending or $337 million) and none in San Francisco. Even before Covid STWD was getting out of those areas due to valuations and focusing on areas with population growth and limited supply.

- Not only is there little exposure to US office space in troubled markets, STWD is only lending 60% on the value of the properties where it has loans. STWD matches durations and it uses more fixed-cost debt and has interest rate floors on the loans. So rising rates boost the spread, but falling rates do not hurt income as much. Plus, with the use of securitizations, CLOs, A-Notes, STWD has minimal exposure to mark-to-market events.

- Real Estate Owned and Non-Accruals are being resolved. STWD has loans of 50%-60% of the value of the properties. Given where the market is for putting new money to work, STWD estimates that it would add 7.5-10.0 cents to quarterly earnings. Their goal is to see much of this resolved in 2Q and 3Q and there are bids coming in and letters of intent being signed that would be at or above STWD's loan amounts.

- The next round of rent increases for the property segment was expected to be announced in May and start taking effect in July. The higher rents should help earnings but have a larger impact on the fair market value for the property, which would boost book value.

- What impresses us is for the last six quarters, office space loans have been in the news as terrible investments – especially the last three quarters. During this time, there have been multiple rate hikes too. Plus, CECL (Current Estimated Credit Loss model) has

required STWD to double its loss reserve to 49 cents per share. Plus, STWD paid out 48 cents/quarter in dividends or $2.88 which reduces book value. And, we know STWD has had several quarters when it held excess liquidity to be defensive which was a drag on earnings as was real estate being sold. Yet book value is up:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
Undeprec Book Value	$21.37	$21.70	$21.69	$21.51	$20.46	$20.74

- The servicing business should also pick up going forward. There is now $107 billion in loans where STWD has been named as the servicer with only $5 billion actively being resolved. There were more commercial loans in 2013-16 that will be maturing going forward too. STWD gets paid when these deals are resolved. If it's a simple refinancing, that's not especially profitable. But given where many banks are now, a higher percentage may require a different capital structure and finding partners to invest. That could move up the profitability per project for STWD. This could be a growing source of income in late 2023-26. Looking at the 1-cent miss for 1Q23 earnings – it looks like lower volumes played a role here as well as the quarter not reporting the closing of any resolutions for a y/y drop of 5 cents for the investing/servicing unit.

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
Invest/Spec Service	$0.04	$0.10	$0.10	$0.11	$0.09	$0.15

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 beat 1Q23 forecasts by 5 cents and admit they picked up 3 cents from minor areas not in guidance. The tax rate came in slightly below guidance for another 2 cents. A large jump in Other income looks like higher interest income on the large cash balance. Guidance for 2Q still sees pressure on the top line. We like that TXN continues to invest in the business and doesn't manage this on a 90-day basis. It would seem likely that share repurchases may be under some pressure until markets grow again – and boost the top line. Lower share count was 2 cents in EPS for 1Q23.

- Inventory continues to build due to slower sales. TXN says every quarter that the bulk of its inventory has a very long technology lifespan, and it does not fear obsolescence. The issue is that it consumes cash flow. TXN still sees this as a way to maximize gross margin by spreading high fixed costs over more units and when gross profit is 65%-75% - it doesn't want to lose sales by being out of stock when markets reverse and grow again. At this point, TXN still sees weakness in several end-markets and customers reducing their own inventories as supply chain issues have been cured. This should occur gain in 2Q.

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
DSIs	195	160	136	126	128	118	114	113	116
Fin Gds DSI	63	50	41	36	40	37	37	40	44

- In 4Q as the Lehi plant came online, we were concerned that depreciation didn't increase. In 1Q23, it played out as forecast, the $66 million restructuring charge for the start-up disappeared and depreciation rose y/y by $65 million. That removes our concern from 4Q.

- After 4Q, we were concerned that stock compensation showed a very modest increase of only $12 million. Again, 1Q saw this snap back with a $30 million y/y increase – that area looks good again.

- R&D and SG&A spending continues as TXN grows. This should leverage again as the top line recovers in the future. An incremental $100 million in revenue is worth about 7 cents in EPS against the $1.85 TXN just produced.

- The new construction may also start to return cash to TXN via tax incentives under the CHIPS Act. It has accrued $619 million in this area under "other L-T assets." It believes that the lag between payments under the new law is about a year after the plant starts operation.

United Rentals, Inc. (URI)

Date Added	12/13/2021
Market Cap	$32.1 B
PE (fwd)	11.9
Short %	3.91%
Current EQ Rating	4+ (Accptable)

URI's 1Q23 adjusted EPS of $7.95 missed by 4 cents. The company confirmed guidance and the market is disappointed by the Ahern deal reducing the EBITDA margin in 1Q23. We would note that 2022's EBITDA margin was 48.3% and guidance URI just confirmed again is for 48.2% in 2023 with Ahern. The higher 2023 sales forecast produces over $1 billion in additional EBITDA. The 10bp drop in margin only offsets that EBITDA growth by $14 million in 2023. URI has also begun paying a dividend.

- URI had bad debt expense rise by $7 million cutting EPS by 7.5 cents.

- Advertising reimbursements fell by $6 million which should have helped EPS by 6.5 cents.

- Share compensation was flat y/y – that normally is a headwind to EPS.

- Share repurchases slowed with the Ahern deal and were only $10 million in 4Q and 1Q23 was slightly below 1Q22 as well – this is a headwind for EPS.

- Adjustments to EPS remain consistent with past policies – restructuring charges after the acquisition were only 2 cents of the $7.95 in EPS and URI always adds back amortization of acquired intangibles.

- Inflation increased the value of acquired fleet equipment. Assigning more of the purchase price to that area means it will be expensed quickly. It also hurts gross margin via higher depreciation on rentals and higher cost of sales with that equipment is sold. This hurt GAAP EPS by 76 cents in 1Q23 and we think this can explain some of the margin decay.

- Ahern was a lower margin business when URI acquired it – 35% vs URI's 48%. URI plans to keep more of the Ahern locations so it is only forecasting $40 million in cost synergies and $60 million in revenue synergies through cross-selling. If successful, without growth from URI – the combined entity's margin would be 47.9%. URI is already forecasting

48.2% for 2023 and reported that it has made progress in the first quarter of owning Ahern toward boosting margin.

- The Ahern acquisition appears conservative to us. Only 5% of the purchase price went to goodwill and the bulk of the price will be amortized or depreciated over short time frames. The price was only 6.5x EBITDA or 4.9x if the synergies are realized.

- We still think EBITDA is too aggressive of a metric because URI's rental equipment depreciation is lower than net equipment purchases – making that depreciation a cash cost. We believe EBITDA should be viewed as $1.0-$1.5 billion lower than what is reported. Under that adjustment, debt rises from 1.7x EBITDA to 2.0-2.2x – still reasonable.

Warner Bros. Discovery (WBD)

Date Added	7/14/2023
Market Cap	$32.1 B
PE (fwd)	16.9
Short %	3.8%
Current EQ Rating	3+ (Minor Concern)

WBD will lap the acquisition in 2Q23 for all but a few days, which should make y/y comparisons and signs of improvement easier to see. This is still a multi-year turnaround story that is running ahead of schedule in several areas. We expect WBD to raise guidance.

- Restructuring and impairment charges are expected to be $4.1-$5.3 billion. $3.8 billion have already happened by the end of 1Q23. The bulk of this is done.

- Cash costs for the restructuring were forecast at $1.0-$1.5 billion. Through 4Q22, the cash costs were $800 million. After 1Q23, WBD has seen $1.2 billion of the cash costs. After 4Q22, it forecast that it was likely to come in near the higher end of cash costs. There may be another $200 million, but this is also nearly done.

- DTC or streaming is another change that has sped up its forecast. The EBITDA loss was $2.1 billion in 2022. It was expected to lose money in 2023 and break-even in 2024. It just posted $50 million in positive EBITDA for 1Q23 and new guidance is a profitable 2023 and 2024 now.

- Streaming customer count is rising, before the relaunch of Max in the spring and ARPU is flat to up. WBD did note that there remains a big opportunity for improvement by reducing churn in that unit but is not factoring that in yet.

- Synergies are rising too. WBD boosted the forecast to $4 billion during late 2022 and it expects a $2 billion impact to be seen in 2023 for EBITDA.

- The downside is advertising remains weaker than before the merger. On a proforma basis, advertising dropped $789 million from 2021 to 2022 and is down $395 million y/y in 1Q23. Some of that is a tough comp vs. the Olympics for 1Q22. WBD sees some turnaround in areas but is not baking in a bounce in advertising as part of guidance. There should be benefits to advertising from having a new market overall with Max and there are some new advertisers signed there for HBO exclusive programing. Also, WBD

reworked the sales team in 2Q and 3Q of 2022 while it was canceling programming. 2023 should not face those headwinds, and having the sales team in place already should help.

- From April 2022-March 2023, Free Cash Flow was $2.1 billion. That figure was impaired by $1.2 billion in cash restructuring costs, a large headwind in receivables of $850 million, and a sizable loss with streaming EBITDA of over $2 billion. Studios were also basically flat in 2022 vs. 2021 despite WBD canceling the release of several movies. Forecasts are only for $4 billion in free cash flow for 2023. WBD can get there by simply having the $2 billion in synergies appear that 2022's actions set up along with the $2.1 billion in trailing 12-months free cash flow. A swing in streaming EBITDA, more movie releases in 2023, lower cash restructuring payments, and lower receivables should all combine to make the guidance conservative.

- EBITDA was $9.2 billion in 2022 and the forecast is for $11.0-$11.5 billion. If it picks up the $2 billion in synergies this target looks very doable too. Swinging the streaming from EBTIDA of -$2.1 billion to a positive figure should help too as should more studio releases. We believe this forecast could be raised during 2023.

- Net debt is $46.3 billion – with $11.5 billion in EBITDA – debt will be 4.0x. The forecast is still for $14 billion in EBITDA in 2024, which lowers debt to only 3.3x assuming nothing is paid down.

- Advertising is a wild card, but it won't stay below normal levels forever. There is likely another $1 billion in EBITDA here that WBD does not have factored into forecasts. Having combined all its channels over the last years with a strong sales force could help WBD boost rates going forward too.

Wesco International (WCC)

Date Added	7/14/2023
Market Cap	$9.1 B
PE (fwd)	10.3
Short %	4.1%
Current EQ Rating	5- (Strong)

WCC's adjusted EPS of $3.75 for 1Q23 beat forecasts by 17 cents. But all of that came from the tax rate being 18.9% vs. guidance for 27%. All the change came from tax benefits from exercising and vesting stock awards. We still see WCC with high-quality earnings with minimal non-GAAP adjustments:

- WCC does not add back the amortization of acquired intangibles like many other companies. That is a positive for adjusted earnings. Also, the merger and integration charges are shrinking and becoming less material to results:

	1Q23	1Q22	2022	2021	2020
Merger/Integration	$19.5	$25.6	$67.4	$158.5	$132.2
Accel. Amortization		$5.4	$9.8	$32.0	
Gain on sale				$8.9	$19.8
Market Value Adj.					$43.7
Adj to Inventory	-	-	-	-	$18.9
Total	$19.5	$31.0	$77.2	$181.6	$175.0

- Inventories grew again. DSI's reached 78 days up from 67 days in 1Q22. WCC was deliberately adding more inventory as orders grew to avoid out-of-stocks. It highlighted that was losing 1%-2% of sales growth in 2022 for this reason. In 1Q23, supply bottlenecks opened more and caused more deliveries to arrive faster than inventory could be shipped to customers. This was almost four days of higher inventory compared to 4Q22 and Management expects this to be worked down during 2023. Unlike other companies that have seen a similar situation, WCC is still posting solid volume growth, which should speed up this process.

- Inventories are accounted for under the average-cost method. Commodity costs are declining now and could provide a tailwind for Cost of Goods Sold and help preserve some gross margin even as pricing gains slow. Initially, we could see pricing decline faster

than COGS, but that gap should narrow. It is also important to remember that boosting cross-selling leverages fixed costs and helps margins. Backlogs are at record highs too, which should help volume growth remain positive. When we adjust for lower pricing but higher volume, in most scenarios, EPS could still increase. Plus, there are volume rebates that impact Sales and Cost of Goods Sold. Lower pricing going forward could impact margins, but the higher volume growth should offset that too.

- Cash flows are under pressure from the higher inventory levels and some higher receivables while payables declined. Management is pointing to some short-term issues such as suppliers delivering faster than WCC's orders to its customers has not matched the same speed yet. It is guiding to working capital being released into cash flow going forward.

- We can envision some choppiness in 2Q results, but at 10x EPS with sales growing with both volume and pricing plus working capital being released to grow cash flow, we believe WCC has a solid growth story.

On Deck Values

AT&T, Inc. (T)

We still like T very much as an idea but believe some other companies offer more upside sooner. The rest of 2023 should represent the peak of AT&T capital spending at $24 billion, declining to $20 billion for 2024 and thus bumping up free cash flow next year.

- The company's plan to apply free cash flow after the dividend toward debt reduction is happening. It is retiring $8 billion in preferred stock with a pre-tax dividend rate of $750 million which will enhance forward free cash flow after the dividend too. It should be able to retire more debt this year and $13 billion in years 2024 and 2025. That will drop debt to EBITDA to the goal of 2.5x and save AT&T $1 billion in interest expense too.

- Even if the enterprise value does not change at all, the lower preferred stock and debt figures should move enterprise value to the common stock. That would approach $5 per share of stock appreciation.

- We still expect growth in total EBITDA and EPS from retiring copper lines, adding incremental customers to completed broadband where heavy fixed costs should remain flat, and pricing on mobility improving along with more customers.

- Fears that Amazon and DISH will crater pricing in the mobile phone business seem overstated. For one thing, AT&T and others already have wholesale customers where they save the cost of marketing and set-up fees. Yet, the bulk of customers still deal directly with AT&T and others. Second, building out a new nationwide phone network would take some time and as investors have seen during the 5G roll-out of T and others is very capital-intensive. A new network that competes nationwide may cost several hundred billion dollars and many years. DISH is currently building a 5G network now and the operation is a huge consumer of its cash. Finally, Amazon and DISH have leverage too, and are not generating free cash flow. Amazon's 2020 cash flow was helped by a surge in payables of $17 billion vs. the more common $3 million boost. DISH's EBITDA is falling and is $3.5 billion against net debt of $19.2 billion or 5.5x. DISH's wireless stats show higher churn and lower revenues per user than any of the established players.

Amazon	2022	2021	2020
CFO	$46,752	$46,237	$66,064
CapX	$63,645	$61,053	$40,143
Acquisitions	$8,316	$1,985	$2,325
Free Cash Flow	-$25,209	-$16,801	$23,596
DISH			
CFO	$3,092	$4,031	$3,312
CapX	$3,712	$1,964	$1,193
Acquisitions	$7,207	-$215	$2,700
Free Cash Flow	-$7,827	$2,282	-$581

Ball Corporation (BALL)

BALL beat estimates by 18 cents last quarter. Roughly 7 cps of this was generated by a benefit from a virtual power agreement settlement. While the company was expecting this benefit, it had not discussed it with the Street so it was not factored into analysts' models. Even without this benefit, the beat appears solid.

BALL must continue to work off its inventory overhang and it may be well into the second half before its customers begin to enjoy any meaningful improvement in volumes. This will keep cash flow under pressure and delay deleveraging. However, we continue to include BALL on our On-Deck Value list as the volumes are almost certain to return, it will begin to enjoy the benefit of inflationary cost pass-throughs in the second half, and costs are likely to continue to moderate. As conditions normalize, the cash flow will return and deleveraging can resume.

- Global can volume was down 1.4% which was in line with expectations. The company is remaining very conservative in its guidance and reduced 2023 guidance of 4% growth to low-single digits on volume. It emphasized that the recovery will be loaded towards the back half of the year and referenced the easy comps the fourth quarter will enjoy.

- BALL's contracts allow it to pass through aluminum costs at the time of sale. Lower aluminum prices pressured sales growth in the quarter. Analysts should remember that while falling aluminum prices will not impact gross profit dollars under these contracts, they will artificially inflate gross margins.

- Many of contracts contain PPI inflators that rise with inflation. Unlike the aluminum pass-throughs, these amounts kick in at contract renewal which will not begin to happen for the bulk of the company's contracts until the second half of the year. Management noted that these provisions generally do not deflate, so even if non-aluminum costs reverse, it will still be able to enjoy the increase in revenue dollars and the moderating or potentially falling costs in the second half.

- BALL's biggest overhang remains its buildup of inventories resulting from lower-than-expected demand in 2022 as its beverage customers saw their volumes collapse due to them raising prices and cutting promotions. The company is working down its raw materials balances and total DSIs were stable YOY at 69.3. This is still elevated when compared to the pre-Covid levels of 45-50 due to higher costs and unexpected slow demand. The reduction in new purchases should help cash flow as the company

continues to work down inventory balances as volumes hopefully pick up in the second half.

- Meanwhile, payables continued to trend down, falling to 115 days compared to 150 a year ago. Payables/Inventory stands at 1.7, compared to 2.0 at 12/22 and 2.2 a year ago. It is important to keep in mind that the decline in payables is a result of a decline in purchases rather than suppliers pressuring the company. They are also being deflated by lower aluminum prices compared to a year ago.

- Pension expense fell by 2.7 cps. Like most companies, higher interest rates are driving up interest cost while pushing service cost down. These two components resulted in a net increase to expense of $5 million. However, this was more than offset by a $9 million increase in the expected return on plan assets and a $7 million decline in the amortization of net actuarial loss. While both of these factors should continue to contribute to lower pension expense during the year, we consider the increase in expected return and the decline in amortization of actuarial loss to be low-quality sources of growth.

- The benefit from the company's extension of useful lives in calculating depreciation continues, adding 6 cps to earnings in the quarter. The new rates went into effect on July 1, 2022, which gives the company one more quarter of non-operational tailwind. Also, amortization of intangibles fell by 1.5 cps driven mostly by the write-off of intangibles related to the Russian operations in the second quarter of 2022.

DocuSign, Inc. (DOCU)

DOCU's adjusted EPS of $0.72 beat estimates by 16 cents. Sequentially, Interest income rose by $4.9 million which is 1.9 cents. We do not think that has much to do with operations. We are impressed that GAAP EPS was $0.00 but included an 11-cent restructuring charge so we again see DOCU posting positive GAAP EPS. We still expect some bumpy results and DOCU may have had too much work in its favor for 1Q and could see some regression in 2Q:

- A big boost to Adjusted EPS came from DOCU spending less than expected. Non-GAAP operating margin was 27% vs. guidance of 21%-22% coming in the quarter. Selling and Marketing was down and R&D was flat in dollar terms. DOCU noted that in 1Q it expected to spend more and still expect that spending to occur through the year. Guidance for the year is now up 100bp for non-GAAP operating margin to 22%-24% - significantly lower than 1Q results. Every 100bp in 1Q was 2.5 cents in EPS. So 12.5-15.0 cents of the 16-cent beat came right here.

- We know the recent layoffs helped too, but that was expected. Still, non-GAAP gross profit margin came in at 83% vs. guidance of 81%-82% and updated guidance is holding at 81%-82% for the year.

- Revenue also beat by $20 million. This added 2 cents to EPS as well. That is despite the negative of fewer customers spending more than the year before and DOCU expects that headwind to continue. Retention which shows y/y change in spending by existing customers came in at only 105% (it has been in the 120s) and management expects that to decline further. We think this represents a solid result, given that the key real estate is still weaker, larger clients are not adding services/users at prior rates.

- The beat also came despite another loss in Professional Services – which again involves training and software set up for clients.

	4/30/23	1/31/23	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Professional Sales	$22.1	$15.9	$21.4	$17.0	$19.4	$16.8	$16.9	$19.1	$17.1
non-GAAP Pro Income	($5.5)	($8.9)	$1.6	($5.0)	($2.5)	($9.6)	($6.3)	($2.6)	($3.2)

This was a $3 million larger loss y/y for 1-cent of EPS headwind.

- Stock compensation came in below 4Q results, but that is common. It was still above the 20% of sales forecast at 21.8%, which added 4.6 cents to adjusted EPS.

	4/30/23	1/31/23	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Sales	$661.4	$659.6	$645.5	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1
Stock Comp	$139.8	$145.9	$135.2	$141.2	$110.7	$118.0	$109.4	$100.0	$81.1
Taxes on Exercise	$4.2	$1.9	$2.5	$3.4	$5.1	$4.2	$10.1	$11.6	$16.3
Total	$144.0	$147.9	$137.7	$144.6	$115.8	$122.2	$119.5	$111.5	$97.4
% of Sales	21.8%	22.4%	21.3%	23.2%	19.7%	21.0%	21.9%	21.8%	20.8%
Stock Comp %	21.1%	22.1%	20.9%	22.7%	18.8%	20.3%	20.1%	19.5%	17.3%

We expect this percentage to decline as sales rise – that may prove to be a headwind.

- The jump in deferred revenues (contract liabilities at DOCU) was again a positive. Management noted a 20% increase in clients over $300,000. Billings to Revenue was mixed as both saw a solid increase of 10% and 12% respectively.

	4/30/23	1/31/23	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Rentention	105%	107%	108%	110%	114%	119%	121%	124%	125%
Billings/Revenue	102%	112%	102%	104%	104%	115%	104%	116%	112%
Deferred Rev DSOs	168	166	157	162	162	166	162	169	163

Coming into 1Q, guidance was for billings to revenues to come in under 100% so the 102% figure was viewed as positive. On the call, DOCU noted that it had a solid number for renewals being confirmed on time during 1Q. That enabled billings to come in at $675 million vs. guidance of $615-$625 million. Management said it is common for more renewals to slip into the next period. Guidance for 2Q is $646-$656 million on billings against $675-$679 million on revenues. That guidance again sets up a forecast for billings/revenues under 100% and for the year it is supposed to be 101%. We also wonder if a higher level of renewals for 1Q could hurt 2Q more.

Kimberly-Clark Corporation (KMB)

- We have been highly critical in the past of KMB's history of taking huge restructuring charges every quarter for many years at a time and unusual movements in reserve accounts that seemed to benefit earnings at just the right time. However, KMB has now gone five straight quarters with no restructuring charges added back to non-GAAP results and we have not seen evidence of unusual benefits from reserve takedowns. This greatly improves the company's earnings quality, in our opinion.

- Prompted by recent FASB requirements, KMB disclosed in its 3/23 10-Q for the first time that it maintains a supply chain finance program under which suppliers can sell their KMB receivables to third-party financing institutions to receive cash faster. Payables to suppliers using the programs amounted to 27% of total accounts payable as of 3/23. We do not have historical information to see how that has grown over the years, but we do know that KMB's days payable are currently 98 which is up from about 85 before the pandemic. This is not excessive when compared to CLX's 139 and PG's 119. Regardless, KMB could see an unexpected cash flow squeeze if higher rates force it to unwind some of its supply chain financing.

- The company has a goal of getting back to its pre-Covid gross margin which was 35% on 12/19 although it is not forecasting that for 2023. Gross margin in the 3/23 quarter was 33.2% so even if there is no more sequential improvement in 2023, gross margin will show a marked improvement over 2022's gross margin of 30.2%. Note that management specifically stated on the call that while sequential gross margin improvement will fade, it does expect the 4Q23 gross margin to be above 1Q's 33.2%.

- The reasonable growth forecast, the low valuation compared to its peers, and the significant improvement in earnings quality prompt us to move KMB to the On Deck Value list.

The Scotts Miracle-Gro Company (SMG)

While we believe SMG represents and very interesting longer-term value, we are maintaining it as an On-Deck Value as trading it will likely be 2024 before the turnaround is clearly in place. Nevertheless, we see positive signs that the company is heading in the right direction.

- Inventory has been worked down by more than $400 million with much of that coming from reductions at Hawthorne. Management is still forecasting a 100 bps decline in gross margin for FY23 ended in June as it works off higher-cost inventory. However, it should be in a good position going forward as raw materials costs decline, production rates ramp back up, and cost-cutting programs are finalized.

- Lower inventories, extended payable terms, and cost cuts allowed the company to reaffirm its guidance for generating $1 billion in free cash flow over the next two years. It expects its leverage ratio to be in the low 5s by the end of the fiscal year which is well below its 6.5x credit covenant.

- Sales in US Consumer were down 1.6% in the 3/23 quarters volumes fell by 10.4% and were only partially offset by pricing of 8.7%. Retailers cautiously kept their inventories lean and were reportedly 6% below last year. Early season sales were soft due to weather in California. However, management was very optimistic on the call about the point-of-sale activity in early April and it has significantly increased its advertising and promotional investment versus a year ago. It remains to be seen if the early strength will carry over to the full quarter and much of the near-term performance will depend on consumer sales in the upcoming quarter. A mild disappointment is not a threat to the long-term value we believe the company represents, but the market will likely punish any shortfall.

- Hawthorne remains a disaster as sales declined by 54% in the quarter. Investors realize this part of the business is essentially being rebuilt and expectations here are minimal.

Stanley Black and Decker, Inc. (SWK)

There is some progress being seen at SWK but we believe this may be more of a late 2023 and 2024 story. However, given that EPS of $8-$9 is possible without SWK even returning to normal, this may be something to start watching more closely.

Adjusted 1Q23 EPS of -$0.41 beat forecasts by 33 cents. The market obviously expected nothing and to beat handily while the y/y decline was from $2.10 to -$0.41 shows that. For earnings quality, we noted the following:

- The warranty accrual dropped again adding 1.0 cents

- Bad debt expense dropped y/y from $11.1 million to $2.1 million adding 4.8 cents.

- Stock Comp was up $4.4 million – costing 2.4 cents.

- Pension costs were up $4.6 million – costing 2.5 cents.

- Losses on selling receivables due to higher interest rates cost 0.4 cents.

- SWK did refinance some commercial paper with $750 million in bonds at 6.00-6.27%. That will hurt EPS going forward.

- Inventory is coming down in dollar terms by $201 million, which is a positive. However, finished goods are flat and DSOs are up because 1Q is seasonally slower than 4Q.

SWK Inv.	**4/1/23**	**12/31/22**	**10/1/22**	**7/2/22**	**4/2/22**	**1/1/22**	**10/2/21**
Finished Product	$3,472	$3,461	$3,840	$4,115	$4,023	$3,486	$2,777
Work in Progress	$260	$339	$357	$456	$429	$395	$350
Raw Materials	$1,928	$2,062	$2,150	$2,065	$1,816	$1,539	$1,007
Total Inventory	$5,660	$5,861	$6,347	$6,636	$6,268	$5,420	$4,134
DSI Finished	102.0	97.4	112.7	117.5	116.5	111.1	98.6
DSI Wrk Progress	7.6	9.5	10.5	13	12.4	12.6	12.4
DSI Raw Mat	56.7	58.0	63.1	59.0	52.6	49.1	35.7
Total DSI	**166.3**	**164.9**	**186.3**	**189.5**	**181.5**	**172.8**	**146.7**

- On the call, SWK noted that customers are still destocking – but the level of SWK inventory to be impacted is more manageable now. It believes retailer destocking should end in 2023.

- SWK is also in the process of eliminating 60,000 SKUs. The first 15,000 are largely done and were in small supply. The remaining 45,000 are not being manufactured so that may be a negative issue for reducing raw materials. It may also be a negative for selling other finished goods if those SKUs need to be cleared from store shelves first.

- SWK lowered Inventory by $775 million from the 2Q22 peak to 4Q22. The goal in 2023 is another $750 million to $1 billion with $200 million achieved in 1Q. That goal still requires some work this year.

- It is tough to clear inventory when there is still lower volumes being sold overall. SWK forecast poor sales for the rest of 2023. The lower Cost of Goods Sold on lower volume makes the DSI figure increase.

SWK Vol.	**4/1/23**	**12/31/22**	**10/1/22**	**7/2/22**	**4/2/22**	**1/1/22**	**10/2/21**
Overall	-11%	-10%	-10%	-13%	-6%	-8%	8%
Tools/Outdoor	-13%	-12%	-12%	-16%	-6%	-8%	11%
Industrial	-2%	1%	5%	4%	-5%	-9%	-1%

- Margins have turned up a bit in the last quarter. That is the first positive change so far. The goal is still to return to a 35% margin – which SWK has achieved in the past so that goal does not sound outlandish:

SWK Margin	**4/1/23**	**12/31/22**	**10/1/22**	**7/2/22**	**4/2/22**	**1/1/22**	**10/2/21**
Adj Gross Margin	23.1%	19.5%	24.7%	27.9%	31.3%	29.0%	32.3%
Ad SG&A %	20.5%	18.3%	18.4%	18.7%	19.8%	20.1%	20.0%

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- As it clears inventory, SWK is running production levels below normal levels. It's selling more product than it replaces. This is a 400-500bp headwind. SWK is forecasting the curtailment will last all of 2Q23. Under a downside scenario, it could last through 4Q23.

- SWK does use LIFO accounting for its US operations (about two-thirds of sales). As the company burns through more inventory built after the commodity inflation as it lowers total stocks – it should be burning through those more expensive LIFO layers. That should be negatively impacting gross margins in the near term.

- The cost-cutting measure in terms of fewer employees, better supply chain processes, and lower costs are expected to be at a $1 billion run rate by the end of 2023 with $430 million achieved after 1Q23. On sales of $16-$17 billion – that's 600bp of margin helping run rate by the end of 4Q23.

- For 2023 – it is all about timing. How long does it take to clear inventory and restart normal production? The goal now is 3Q, but it could stretch to the end of 4Q And, are the $1 billion in near-term cost reductions complete? Those two issues are 1000bp of margin gain going into 2024. Even at $16 billion in sales and assuming $120 million additional interest expense – that would add $7.50-$8.00 into EPS going forward. 4Q22 was -$0.10, 1Q23 was -$0.41, 2Q23 is forecast at $0.35. For a $95 stock, adding $8 into forecasts in before year-end could be a game changer.

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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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