BEHIND THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers 3Q ’22 Focus List

Top Risks

Company	EQ Rating	Date Added	
Altria Group (MO)	2- (Weak)	6/11/2021	p. 4
Cloudflare, Inc. (NET)	3- (Minor Concern)	7/8/2022	p. 6
The Coca-Cola Company (KO)	3- (Minor Concern)	3/30/2022	p. 8
Conagra Brands (CAG)	2- (Weak)	10/8/2021	p.10
Colgate-Palmolive Company (CL)	3- (Minor Concern)	7/8/2022	p.12
General Mills, Inc. (GIS)	3- (Minor Concern)	9/27/2022	p.14
The Hershey Company (HSY)	3- (Minor Concern)	7/8/2022	p.16
International Business Machines Corporation (IBM)	2- (Weak)	3/12/2021	p.18
Iron Mountain Incorporated (IRM)	1- (Strong Concern)	12/4/2020	p.21
Keurig Dr Pepper Inc. (KDP)	2- (Weak)	12/4/2020	p.24
Mohawk Industries, Inc. (MHK)	2- (Weak)	9/27/2022	p.26
Mondelez International, Inc. (MDLZ)	2- (Weak)	12/4/2020	p.28
Okta, Inc. (OKTA)	3- (Minor Concern)	9/26/2022	p.30
Post Holdings, Inc. (POST)	3- (Minor Concern)	3/30/2022	p.32
Sealed Air Corporation (SEE)	2+ (Weak)	12/4/2020	p.34
Sysco Corporation (SYY)	3- (Minor Concern)	6/11/2021	p.36

On Deck Risks

Company	EQ Rating	Date Added	
Kyndryl Holdings, Inc. (KD)	na	12/13/2021	p.18
Teva Pharmaceuticals Industries Ltd. (TEVA)	3- (Minor Concern)	12/13/2021	p.37

Top Values

Company	EQ Rating	Date Added	
Air Lease Corporation (AL)	4+ (Acceptable)	9/27/2022	p.39
Air Products and Chemicals, Inc. (APD)	4+ (Acceptable)	5/12/2022	p.42
AT&T Inc.(T)	4+ (Acceptable)	3/12/2021	p.44
LyondellBasell Industries N.V. (LYB)	*5+ (Strong)*	7/14/2021	p.47
Mowi ASA (MHGVY)	*5+ (Strong)*	12/4/2021	p.49
National Instruments Corporation (NATI)	*5+ (Strong)*	3/12/2021	p.51
Starwood Properties Trust, Inc. (STWD)	*5+ (Strong)*	2/8/2022	p.53
Texas Instruments Incorporated (TXN)	*5+ (Strong)*	3/12/25021	p.54
United Rentals, Inc. (URI)	4+ (Acceptable)	12/13/2021	p.56

On Deck Values

Company	EQ Rating	Date Added	
Ball Corporation (BALL)	3- (Minor Concern)	9/27/2022	p.58
DocuSign, Inc. (DOCU)	4- (Acceptable)	7/8/2022	p.60
Otis Worldwide Corporation (OTIS)	5+ (Strong)	7/8/2022	p.62
The Scotts Miracle-Gro Company (SMG)	4- (Acceptable)	9/27/2022	p.64
Warner Bros. Discovery, Inc. (WBD)	3- (Minor Concern)	9/27/2022	p.66

Summary of Changes to the 3Q'22 BTN Focus List

Added to Top Risks

General Mills, Inc. (GIS)	Added 9/27/2022
Mohawk Holdings, Inc. (MHK)	Added 9/27/2022
Okta, Inc. (OKTA)	Added 9/27/2022

Removed from On Deck Risks

Mohawk Industries. Inc. (MHK)	Removed 9/27/2022
Ecolab Inc. (ECL)	Removed 9/27/2022

Added to Top Values

Air Lease Corporation (AL)	Added 9/27/2022

Added to On Deck Values

Ball Corporation (BALL)	Added 9/27/2022
The Scotts Miracle-Gro Company (SMG)	Added 9/27/2022
Warner Bros. Discovery, Inc. (WBD)	Added 9/27/2022

Removed from On Deck Values

Air Lease Corporation (AL)	Removed 9/27/2022
Lamb Weston Holdings, Inc. (LW)	Removed 9/27/2022

Overview of the BTN Focus List

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

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

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

Top Risks

Altria (MO)

Date Added	6/11/2021
Market Cap	$75.1 B
PE (fwd)	8.6
Short %	0.9%
Current EQ Rating	2- (Weak)

For 2Q22, MO's adjusted EPS of $1.26 beat forecasts by only 1 cent. It only grew EPS by 3 cents y/y despite several tailwinds:

- A lower share count added 3 cents

- It added back higher litigation/healthcare costs – producing 2 cents. We expected this as courts have reopened after a Covid reprieve.

- It does not quantify the figure, but in 2Q21 MO had marketing costs to roll out IQOS (Heated Tobacco Products) and those did not occur in 2Q22 – that helped EPS too.

Smoking took another 15-cent price hike on cigarettes and volumes declined by 10% adjusted for trade inventory movements. That comes after -8% in 1Q22 and -8% in 4Q21. That is due to a combination of higher food and gas prices competing for customer smoking dollars. MO used to manage the decay of volumes with price hikes that grew smoking income. Now, the acceleration of decay by losing new under-21 smokers and inflation programs are making this equation unsustainable, in our view:

- Smoking revenues declined y/y in 2Q22 by 2.9%. The net figure of -0.7% looks better only because the price hikes leveraged the excise taxes that didn't change in amount per pack. Also, MO cut promotional spending that is deducted from revenues.

- Smoking operating income declined y/y by 0.5% and that was cushioned by the absence of IQOS marketing and helped by lower marketing on cigarettes.

- Marlboro lost share to discount brands – which may make it more difficult to take enormous price hikes.

- Smoking is still 87% of the basis for MO’s cash flow.

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

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

Cloudflare, Inc. (NET)

Date Added	7/8/2022
Market Cap	$17.8 B
PE (fwd)	Na
Short %	4.6%
Current EQ Rating	3- (Minor Concern)

NET's non-GAAP EPS of 0 cents beat forecasts by 1 cent for 2Q22. We can find the full penny from three non-operating areas:

- Other income, which is FX gains or property sale gains, added 0.3 cents
- Non-GAAP Interest expense swung to income and added 0.4 cents
- Taxes were lower and added 0.2 cents

As we feared, NET's adjusted EPS of $0.00 vs. -$0.02 in 2Q21 was fueled by ignoring the cost of acquisitions and paying greater amounts of wages with stock. The company remains free cash flow negative despite adding back stock comp, and that is getting worse:

	2Q22	2Q21
GAAP EPS	-$0.20	-$0.12
Stock Comp	$0.18	$0.08
Amort Acquired Intangibles	$0.02	$0.00
Amort Debt Issue Costs	$0.00	$0.03
Tax Adjustments	$0.00	-$0.02
Non-GAAP EPS	$0.00	-$0.02
Free Cash Flow	-$4.4	-$9.8
Stock Comp	$57.5	$24.1

- Free Cash Flow remains poor despite adding back stock compensation:

	Q1 22	Q1 22	Q4 21	Q3 21	Q2 21	Q1 21	Q4 20
T12 Free Cash Flow	-$99.9	-$105.3	-$43.1	-$75.2	-$53.3	-$63.7	-$92.1
T12 Stock Compensation	$169.3	$136.1	$117.3	$93.6	$81.5	$72.0	$63.5

- Free Cash Flow is worse than this as the company is stretching payables and accrued expenses:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Payables	$55.7	$32.9	$26.1	$34.6	$29.6	$20.5	$14.5
Accrued Exp.	$53.2	$40.9	$38.1	$33.8	$33.5	$24.0	$20.2
Non-GAAP COGS	$49.5	$45.2	$40.3	$35.8	$33.5	$30.9	$27.6
DSPs	203.3	146.9	146.5	175.9	171.2	129.8	115.5

Non-GAAP COGS removes stock compensation and amortization of intangibles. Free cash flow is already a huge negative figure of -$100 million for the last twelve months and it already includes adding back $169 million of employee pay and it is being helped by rising deferred revenue that increased by $78 million in the last year. Deferred Revenues more than offset Receivable growth of $46 million. And there was $46 million in cash flow from payables and accrued expenses rising.

- Free Cash Flow is worse because NET ignores the cash cost of acquisitions that it makes. That was an outflow of $92.5 million in the last year vs. the already negative $100 million in free cash flow.

- NET just reported a 0% non-GAAP operating margin for 2Q22. To reach that figure, it added back $57.5 million in stock compensation which was 24.5% of sales. It also added back $6.2 million in amortization of acquired intangibles and acquisition costs of just under 3% more of sales. Its goal is a 20% non-GAAP operating margin, which we think means it will need to exclude about 47% of GAAP costs. Does that mean employees are going to accept 40% or more of their pay in stock? Plus, the bulk of the cost-cutting is expected to come from Sales and Marketing which is supposed to decline 1500bp. The company needs to maintain fast revenue growth to help paint a picture that the stock is a valuable currency – but it wants to reduce Sales and Marketing?

The Coca-Cola Company (KO)

Date Added	3/30/2022
Market Cap	$253.4 B
PE (fwd)	23.8
Short %	0.69%
Current EQ Rating	3- (Minor Concern)

KO's 2Q22 adjusted EPS of 70 cents beat forecasts by 3 cents. It did not raise guidance for adjusted EPS after beating by 6 cents in 1Q22. This latest 3-cent beat did not cause KO to raise EPS guidance either, and KO also cut the expected loss of Russian/Ukraine-related business from 4 cents in 2002 to 3 cents.

- Depreciation and Amortization declined by $61 million y/y and added 1.1 cents. It's also worth noting that with huge price hikes and acquisitions, KO is picking up even more in margin leverage in this area. Depreciation and Amortization declined relative to sales to 318bp in 2Q22 vs 536bp in 2Q21 – an increase of 218bp for operating margin. But, adjusted operating margin fell 100bp y/y despite this huge tailwind.

- KO continues to reduce bad debt reserves in dollar terms even as price hikes drive up the dollar level of receivables. Bad debt reserves rose with Covid as many would expect. However, they are now below pre-Covid levels with a much larger receivable. Reserves in the second quarter were 10.2% of receivables of $510 million vs. roughly 11% of $525 million in receivables for the quarters pre-Covid. This is adding to EPS too.

- We wonder if KO will face some inventory issues too. Despite boosting its inflation forecasts for commodity prices and its COGS rising at 19%, KO's inventory is rising at half that rate in dollar terms. DSIs are falling too to the lowest level in three years. That tells us that unit inventories are declining even faster. If KO has been taking price hikes and not replacing inventories, its margin performance of late may be very difficult to maintain if higher-cost inventories need to be purchased and expensed.

	2Q22	1Q22	4Q21	3Q21
Adj COGS	$4,634	$4,233	$4,042	$3,908
Inventory	$3,621	$3,741	$3,414	$3,182
DSI	71.1	80.4	76.9	74.1

	2Q21	1Q21	4Q20	3Q20
Adj COGS	$3,904	$3,556	$3,661	$3,508
Inventory	$3,281	$3,356	$3,266	$3,264
DSI	77.3	85.9	86.5	84.7

	2Q20	1Q20	4Q19	3Q19
Adj COGS	$3,038	$3,291	$3,605	$3,717
Inventory	$3,501	$3,558	$3,379	$3,266
DSI	104.9	94.1	89.0	80.0

- FX headwinds are returning and Latin America growth continues to look unsustainable as KO is still taking large pricing gains with minimal FX hits. However, this looks likely to end in 3Q as KO has a very tough comp and FX is becoming a headwind again:

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

The drop in volume in 2Q22 was due to timing issues and should bounce back in 3Q. However, look at 3Q21- KO took a 23% price increase and enjoyed 7% positive FX for a net 30% jump in pricing. Since then, it's been 12%, 13%, and 11%. 3Q22 could see a much more subdued result for Latin America which has been a key part of KO's reported organic growth.

- We also want to remind investors that KO could be required to post over $4 billion in cash if it loses its tax case on transaction splitting with the IRS. That case remains on hold until the tax court resolves a similar case involving 3M.

Conagra Brands, Inc. (CAG)

Date Added	10/8/2021
Market Cap	$16.5 B
PE (fwd)	14.2
Short %	1.9%
Current EQ Rating	2- (Weak)

CAG's adjusted EPS of 65cents beat forecasts by 2 cents. CAG cut advertising to $46.1 million from $75.2 million last year and $59.2 million in 4Q20. That drop alone in dollar terms was 4.7 cents of EPS for the quarter. Stock compensation fell from $22.8 million to a credit of $0.7 million. This added 3.8 cents to EPS in 4Q22. Depreciation fell by $8.2 million adding 1.3 cents to EPS.

Even the company expected its JV income to rise again from the milling operations, this occurred, rising to $47.5 million vs. $33.4 million last year adding 2.3 cents this quarter. We will also point out that CAG took 13.2% in price hikes for 4Q22, which is understandable with inflation. However, we know stores are pushing back on this. If CAG lost 100bp of the price increase and only could push through a 12.3% increase, it would have cost it 4.4 cents in quarterly EPS. It is reporting more price hikes for 1Q23 and 2Q23, on top of already implemented pricing – yet it is saying organic growth will decline. That sounds like severe drops of volume are expected.

- Adjusted operating margin rose by 100bp last quarter, which CAG attributes to its prowess in controlling costs. We see that falling stock compensation was 81bp and deprecation 46bp of the improvement. Plus, CAG had significant price hikes. If inflation falters, margins could drop meaningfully.

- Higher DSIs for inventory plus FIFO accounting could be a minor tailwind for margins in the near term. We would not compare to fiscal 4Q20 as that represented the Covid panic-buying in grocery stores. Higher DSIs could pressure CAG even more if it loses more volume.

Inventory DSIs	f22	f21	f20
1Q	90.1	77.1	92.8
2Q	73.6	70.3	79.9
3Q	72.7	71.6	80.3
4Q	80.6	77.5	56.8

- If we make a simple index from CAG's organic growth figures since 2018, it is clear that CAG is selling less product now than in 2018:

	4Q22	4Q21	4Q20	4Q19	4Q18
Price Index	117.4%	103.7%	101.0%	100.5%	100.0%
Volume Index	97.6%	104.2%	119.5%	98.8%	100.0%

Colgate-Palmolive Company (CL)

Date Added	7/8/2022
Market Cap	$63.0 B
PE (fwd)	25.0
Short %	1.7%
Current EQ Rating	3- (Minor Concern)

- CL beat estimates by a penny in the 6/22 quarter. It raised its guidance for organic sales growth for the year to 5-7% from the previous 4-6%. However, it increased its estimated headwind from FX by 1% and is calling for GAAP sales growth near the high end of its previous estimated range of 1%-4%. It also raised its outlook for raw material inflation which will result in a non-GAAP EPS decline in the "mid-single digits." We noted the one-cent beat included 1.4 cps from higher adjusted other income and about 1.5 cps from a decline in the allowance for bad debt percentage.

- CL has a long history of huge, ongoing restructuring charges which erode the quality of non-GAAP results when these charges are added back. We also note that there has been little in the way of sustainable margin improvement after the billions of dollars that have been spent. After a two-year break from such charges, CL announced a new plan in the 3/22 quarter and added back 8 cps in charges to non-GAAP EPS. We observe that CL's EPS has been a penny above or below targets for several quarters in a row while its peers fluctuated significantly in the same time frame. We are always skeptical of such a pattern, particularly when it is accompanied by much larger add-backs of expenses characterized as non-operating. The current plan should be monitored for expansion of its scope and size.

- One of the biggest concerns we have with CL's recent growth is how it is centered in Latin America. Latin America accounts for 25% of revenue but was 50% of the growth in the latest quarter. This came courtesy of 12.5% organic revenue growth that featured no volume growth and 12.5% in price increases. The company was increasing prices in Latin America by 9-10% a couple of years ago to offset rapidly deteriorating FX rates. Now the company is pushing through a 12% price increase when FX has turned to a tailwind. We have seen similar disproportionate contributions from Latin America in PEP's results and are skeptical that this geography can sustain such strength for long. When asked about the dynamics of Latin America on the conference call, CL was curiously silent.

- We also observe that CL has benefitted from improving FX rates in Latin America while FX in its other markets has turned sharply against it. Now, Latin America FX may be reversing as well.

- The other concerning source of growth is Hill's Pet Nutrition which accounts for only 20% of sales but over 50% of sales growth in the quarter. Organic growth jumped to 18% on top of 15% growth in the year-ago period. Pricing growth of an eye-popping 12.5% did not stunt volume growth which accelerated to 5.5%. However, pricing comparisons in the Hill's segment get more difficult in the back half of the year:

Hill's Pet Nutrition	6/30/2022	3/31/2022	12/31/2021	9/30/2021	06/30/2021	3/31/2021	12/31/2020
Organic Volume	5.5%	4.0%	7.0%	11.0%	10.5%	3.0%	11.0%
Pricing, Coupons, Incentives	12.5%	9.0%	6.0%	8.0%	4.5%	4.0%	3.5%
Organic Sales Change	18.0%	13.0%	13.0%	19.0%	15.0%	7.0%	14.5%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	-3.5%	-2.0%	-1.0%	1.0%	3.0%	2.5%	1.5%
Reported Sales Change	14.5%	11.0%	12.0%	20.0%	18.0%	9.5%	16.0%

So far, the contention that people who bought pets during the pandemic will continue to spend on premium food has held up which has been good for CL as it is a key driver of the company's growth. We do note that GIS reported a volume decline of 1% in its pet segment in the recently reported August quarter. Investors should pay very close attention to results in this segment in the next two quarters.

- Advertising is expected to be flat as a percentage of sales in the back half which will take away a recent tailwind from advertising cuts.

General Mills, Inc. (GIS)

Date Added	9/27/2022
Market Cap	$47.0 B
PE (fwd)	19.3
Short %	2.2%
Current EQ Rating	3- (Minor Concern)

GIS reported non-GAAP EPS of $1.11 in fiscal 1Q23 beating forecasts by 11 cents. That beat included a 3-cent headwind from pension items and 1 cent in higher stock compensation. Share repurchases added 2 cents, a lower tax rate added 3 cents. In fiscal 2022, GIS's tax rate dropped due to a change in the valuation allowance for tax loss carryforwards. Some of the lower tax rate in 1Q23 was expected, but it is unlikely to drive earnings as much going forward as GIS laps the lower rates seen in 2022.

The biggest driver here was a 15% price increase for the company, which contributed to volumes falling 5%. That follows fiscal 4Q22 where pricing was 14% and volume fell 2%. We believe that pricing largely falls to the bottom line. Losing 1% of the price hike would have cost GIS about 6-7 cents of EPS.

GIS boosted guidance too. Organic growth is now expected to be 6%-7% vs. 4%-5%. That is being driven by more pricing and less promotional activity. GIS thinks the bulk of its volume losses already seen are the result of customers trading away from GIS due to a lack of promotions. Some of the increase in guidance is due to the belief that customers will return as they hit easy volume comps. EPS growth is expected to be only 2%-5% before FX hits– if they find they come in 100bp below forecast on pricing, that is enough to eliminate EPS growth and probably why GIS started the fiscal year forecasting 0%-3% EPS growth before FX.

- Walmart and Kroger are saying on their conference calls that they expect to keep pricing on food items as low as possible and expect their suppliers to help in that area too. Also, they are highlighting that consumers are switching away from branded items toward cheaper store-brand substitutes and the stores are getting faster growth in that area. As noted above, if customers push back even just a little on price hikes – every 1% GIS doesn't pull through is about 7 cents per quarter in EPS.

- GIS is still not growing its inventory at rates that correspond to 14% and 15% inflation. Total inventory was $1.87 billion at the end of May vs. $1.82 billion the year before. Raw materials were up 29% and grains up 48% within that total. But total DSIs were down by more than three days y/y. For August, DSIs were up over two days y/y with raw materials up 36% but more interesting grains fell 4% y/y. Grains are now at the lowest dollar figure since May 2021 – that may be an omen that the full price hikes will be difficult to maintain throughout this fiscal year.

- The huge price hikes may have already helped. Adjusted gross margin still fell 70bp y/y for 4Q22 and 3Q22 saw a decline of 160bp y/y. But for 1Q23, adjusted gross margin rose 20bp y/y. That may make it difficult to push through even higher price hikes too.

- GIS blamed inflation and supply chain deleveraging. Lower volumes should deleverage supply chains too. We have speculated that gross margins may have been helped already by liquidating LIFO layers and tapping older inventory at lower price points. That may be harder to continue too.

- Higher prices are leveraging operating costs. But GIS also cut some expenses in dollar terms too which gives an added boost to cost leverage. Advertising and promotion were scaled back in fiscal 2022. GIS guided to more spending here coming into the last quarter.

	f22	f21	f20
Advertising	$690.1	$736.3	$691.8
Accrued Trade Promotion	$474.4	$580.9	$550.9

  Lower promotional spending boosts revenue as it is netted against sales and lower advertising against higher revenue boosts margin. It is interesting that GIS is very upfront that is conceding some volumes by slowing promotional activities. It now plans to keep promotional spending lower during 2023 and thinks competitors will do the same. That is some of the source for the raised guidance after 1Q23 results. This looks like a risk to pricing too if volume losses hold or accelerate and GIS needs to boost this spending.

- Free cash flow has been helped by payables rising by $500 million y/y and 3.7 days of payables. This is happening as inventory days decline and could become a cash flow headwind.

- Watch out for more international headwinds too. Last quarter international volumes were down 7% organically and FX was only a 5% headwind there vs. 2% in earlier quarters. We have seen many companies reducing forecasts due to higher FX hits coming for the rest of calendar 2022.

The Hershey Company (HSY)

Date Added	7/8/2022
Market Cap	$45.9 B
PE (fwd)	27.3
Short %	1.7%
Current EQ Rating	3- (Minor Concern)

HSY's 6/22 quarter's non-GAAP EPS of $2.53 topped estimates by 12 cps while revenue was also above consensus by $134 million. EPS was penalized by 4.8 cps from an increase in other expense from higher write-downs in equity investments qualifying for tax credits and higher non-service components of pension costs. The company raised its full-year sales growth guidance to 12-14% from the previous 10-12% and raised its non-GAAP EPS growth guidance to 12-14% from 10-12%. However, we see several headwinds in the second half.

- Inventory levels declined again despite higher raw materials costs. HSY uses LIFO for about 60% of its inventories. However, it has allowed its inventories to work down over the last several quarters:

	7/3/2022	4/3/2022	12/31/2021	10/3/2021
Raw Materials DSI	26.7	24.7	26.8	27.9
Goods in Process DSI	11.2	9.7	7.5	9.1
Finished Goods DSI	57.5	44.1	44.0	45.8
Adjustments to LIFO DSI	-12.8	-12.1	-11.2	-11.8
Total Inventory	82.6	66.4	67.0	71.1

	7/4/2021	4/4/2021	12/31/2020	9/27/2020
Raw Materials DSI	35.2	32.4	30.1	24.5
Goods in Process DSI	12.0	8.8	8.1	9.0
Finished Goods DSI	57.8	40.4	50.1	51.6
Adjustments to LIFO DSI	-14.5	-12.9	-13.6	-13.2
Total Inventory	90.5	68.7	74.8	72.0

	6/28/2020	3/29/2020	12/31/2019	9/29/2019
Raw Materials DSI	34.6	26.5	21.5	21.7
Goods in Process DSI	13.2	9.6	7.9	9.4
Finished Goods DSI	69.1	46.2	48.9	57.1
Adjustments to LIFO DSI	-17.4	-14.3	-13.5	-13.3
Total Inventory	99.5	68.0	64.8	74.8

Gross margins are likely benefitting from the delay in replenishing inventories at higher costs which will reverse when it rebuilds inventory in the second half. However, despite this benefit, adjusted gross margin suffered a significant decline in the second quarter:

	7/3/2022	4/3/2022	12/31/2021	10/3/2021
Adjusted Gross Profit Margin	43.9%	45.8%	43.5%	44.3%

	7/4/2021	4/4/2021	12/31/2020	9/27/2020
Adjusted Gross Profit Margin	46.4%	45.8%	43.9%	45.4%

	6/28/2020	3/29/2020	12/31/2019	9/29/2019
Adjusted Gross Profit Margin	46.4%	46.6%	43.4%	44.8%

Gross margins have likely received a tailwind from the delay in replenishing inventories at higher costs, but this could reverse to a headwind as the company rebuilds inventories in the upcoming quarters.

- Supply chain disruptions led to a decline in retailer inventories of HSY's products. However, 6% of the company's North American Confectionary sales growth was driven by restocking the retailer channel. The disappearance of the restocking tailwind and an expected increase in price elasticity are expected to result in volume declines in the second half.

- Advertising rose by 3% in the quarter, well below the 19% increase in sales. The company also noted its net pricing result of 9.5% included 2.5 points from lower promotional spending. This is likely driven by product availability issues, but we estimate the lower promotional spending added about 19 cps to earnings in the quarter. Nevertheless, the company expects to increase promotional activity and advertising in the back half. Its outlook now includes a "low-single-digit" increase in advertising expense for the year whereas before it was calling for advertising to remain flat. It also explicitly called for advertising growth to outstrip sales growth next year.

- Management stated that it does not expect recent pricing actions to impact sales until the fourth quarter but has indicated it expects pricing to rise by "high-single digits." The company raised sales growth guidance by 200 bps but it has indicated volumes will decline. Increased promotional activity will be a net drain on pricing. To expect net pricing to drive higher sales with declining volumes and rising promotional activity puts a great deal of pressure on the company to realize all of its price increases without higher-than-expected elasticity dragging down volume more than expected.

International Business Machines Corporation (IBM)

Date Added	3/12/2021
Market Cap	$110.8 B
PE (fwd)	13.2
Short %	2.6%
Current EQ Rating	2- (Weak)

IBM's 2Q22 adjusted EPS of $2.31 beat by 2 cents. We believe IBM's 2Q EPS received over 20 cents of benefit from one-time or short-lived sources net of minor headwinds. Some of these will reverse in 3Q too. Here is what we saw in the 10-Q:

- Adjusted Other (Income) and Expense had a huge increase y/y in 2Q from $16 million in income to $418 million. IBM pulls out all items related to retirement and Kyndryl for the adjusted figure. We see that it still included a $232 million pretax gain on the divestiture of its healthcare software assets. This is classified as "other" within the Other Income. This is a one-time item and depending on whether it was taxed at 21% or IBM's effective tax rate of 16.4% - this added 20-21 cents to EPS.

- On the call, IBM claimed it took the opportunity of this gain to book losses on stranded assets for $75 million and noted that the gain offset $100 million of losses to wind down the Russian business. That still leaves $57 million of gain that won't recur, which is still 5 cents in EPS for a company that beat by 2 cents.

- As we expected, IBM benefitted again from lower workforce rebalancing in SG&A. This charge declined from $107 million to $28 million y/y and that $79 million was worth 7 cents in EPS for 2Q22.

- It is important to remember that workforce rebalancing is unlikely to be a source of profits in 3Q22 or 4Q22 as it had a $0 there for 3Q21 and a $60 million credit for 4Q21:

Workforce Rebalance	4Q	3Q	2Q	1Q
2022			$28	$5
2021	-$60	$0	$107	$94

- We estimate that of IBM's $421 million y/y drop in depreciation, only $349 million was due to spinning off Kyndryl (that was Kyndryl's depreciation in 1Q22). That $72 million difference added another 7 cents to EPS.

- Related to depreciation falling, we noted that Kyndryl had only $180 million in capital spending in 1Q21 and 1Q22 and $752 million for all of 2021 and no spending on capitalized software. Yet, IBM's investment in these areas is falling more than that:

	2Q22	2Q21	1Q22	1Q21
Capital Spending	$339	$560	$281	$494
Cap. Software	$172	$204	$169	$175

- One headwind for EPS was bad debt expense moving to $6 million in expense from a $22 million credit y/y in 2Q – that cost IBM 2.6 cents in EPS.

- Another headwind was stock compensation rising by $10 million y/y which cost 1cent in EPS.

- We will point out again that IBM just reported almost flat R&D in dollar terms before stock compensation at $1.615 billion, up $24 million or 1.5% y/y. Yet gross margin was down 200bp, despite sales rising 10.8%. The reason for the margin decline was rising labor costs. Why isn't R&D being impacted by that too? The discussion in the 10-Q indicated R&D was up 4% and fell back 2% from FX. This still looks like an area where IBM picked up at least 3 cents in EPS during 2Q22.

- IBM cut its forecast for Free Cash Flow to $10 billion for the year. We would add that IBM continues to make acquisitions to help its growth and R&D and it does not consider that in Free Cash Flow. So, of the $3.3 billion of free cash flow through 6 months, IBM is not including $0.9 billion in acquisitions that would make reduce it to $2.4 billion. IBM has also seen a sizeable drop in financing receivables in 2Q that added $1.3 billion to cash flow.

- Kyndryl's forecasts are for negative growth, yet IBM continues to see much of its growth coming from Kyndryl areas. Software sales were up 6%, 11.6% without FX hits, but 7% was from KD. This is the largest division at 41% of sales, with the highest margin – generating 59% of gross profit. It sure looks like KD is the bulk of the growth here. Within Software, transaction processing was up 12%, 19% without FX hits, but 22% was from

KD. If we look at Infrastructure support, IBM said growth was -2% or up 5% without FX but KD was 8% of the gain.

Iron Mountain Incorporated (IRM)

Date Added	12/4/2020
Market Cap	$13.6 B
P/FFO (fwd)	15.9
Short %	6.0%
Current EQ Rating	1- (Strong Concern)

IRM beat forecasts for normalized FFO (Funds from Operations) by 2 cents coming in at 74 cents vs. estimates of 72 cents. AFFO came in at 93 cents. IRM touted new growth in many areas but held guidance flat. We believe large price increases drove much of the recent growth. Also, most of the growth was in services such as shredding, picking up/returning documents, and transferring from paper to other media. That revenue declined about 25% during Covid and has been slowly bouncing back since mid-2021. It was further fueled by an acquisition made early in 2022. It was the same story when it comes to poor earnings quality for IRM in 2Q22:

- IRM cut bad debt reserves from 6.1% in 4Q21 to 5.4% in 1Q22 to now 4.8% for 2Q22. That generated 3 cents in FFO and AFFO and produced the entire beat.

- FFO and AFFO both added 3.3 cents by ignoring the principal payments on financing leases.

- Acquisitions are a way of life for IRM and so are acquisition costs. Both FFO and AFFO were helped by adding back 6 cents related to acquisition costs in 2Q22.

- AFFO was helped by ignoring cash spending on fulfillment costs and customer inducement payments. These are rising again with service revenues and were 7.7 cents of cash expense that was added back in 2Q.

- AFFO enjoyed another drop in maintenance capital spending both y/y (adding 1.2 cents) and sequentially (adding 0.8 cents).

- Non-cash rent expense was added back to AFFO for 1.5 cents and IRM's estimate of what rent could be raised to in the future helped AFFO another 0.6 cents.

- Stock option expense rose and was added back for 6.9 cents to AFFO.

- Operating lease expense rose 3.5% y/y with all of the recent sale-leaseback deals.

- AFFO is supposed to represent a free cash flow measure to show dividend sustainability. AFFO was 93 cents per share vs. 61.85 cents in dividend. But we see 27 cents of adjustments to AFFO which makes the equation 63 cents of cash flow vs. 61.85 cents of dividend, and we haven't looked at working capital or acquisition costs.

IRM is now launching a new Growth Program called "Matterhorn" that will spend $4 billion to accelerate growth for its Data Center Business over 4 years. That should at a minimum result in some additional debt and lower dividend growth in our view. It also relies on growth in the storage business via higher volumes and price hikes. We see several problems with this on the surface:

- Debt is already higher than the market thinks. Debt to IRM's adjusted EBITDA was $9.9 billion over $1.734 billion or 5.7x. We would add the $275.1 million contingent payment for the latest acquisition and subtract the cash expenses for service fulfillment and principal payments on financing leases. That would make the ratio $10.2 billion over $1.617 billion or 6.3x.

- IRM announced 8.2% organic growth for storage, but only 50bp due to volume. Pricing can be a big help in boosting earnings. If IRM could not boost prices by almost 8% and came in 100bp lower in just the Storage Rental revenue – it would have cost it $7.2 million in AFFO or 2.5 cents and it would be below the dividend considering the other 30 cents of items added back to AFFO that are recurring and/or cash costs. Big price increases can cause customers to rethink just how much they need some of those older documents. And the base business, despite acquisitions, is still declining:

	2Q22	1Q22	4Q21	3Q21
RIM Vol	696.55	699.10	700.87	702.62
Adjacent Vol	8.16	8.08	7.93	7.96
Consumer Vol	25.29	20.47	17.44	16.25

- IRM's storage unit does not do well in recessions either. When companies start looking for areas to save money, they take documents back or have more of them destroyed seeing less need to keep them. Price hikes can accelerate that change. In annual reports from 2009-2015, the company had language like this (from the 2010 annual report:)

> *"We believe that companies that have outsourced records management services are less likely during economic downturns to incur the move-out costs and other expenses associated with accelerating destructions of their records, switching vendors or moving their records management services programs in-house.* ***However, during the current***

recession, which is more severe and has lasted longer than other recent downturns, destruction rates have increased as some customers have been more willing to incur additional short-term service costs in exchange for lower storage costs in the long-term. *In addition,* ***we have experienced longer sales cycles and lower incoming volumes from existing customers****, due in large part we believe to high unemployment rates and generally lower levels of business activity."*

Even long after the recession, IRM didn't recover. We found the records stats in a 2016 presentation. IRM had 358M CuFt of storage at the end of 2011, with acquisitions, it was 377M CuFt by the end of 2015, up 5.3% total. However, during those four years, existing customers still took back 30M, destroyed 69M, added only $79M, and it only found new customers adding 23M. That's organic growth of 3M or 0.8% over four years. And that was AFTER 2008-2010 when the situation was worse.

- IRM enjoyed a big drop in fulfillment and inducement costs to service new business during Covid. These were slow to recover in 2021 but are starting to increase again. These cash expenses are now rising again:

	YTD 22	YTD 21	2021	2020	2019	2018
Cash Service Costs	$38.7	$36.5	$71.8	$75.0	$131.7	$98.7

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

	2Q22	2Q21	1Q22	1Q21	2021	2020	2019
AFFO	$270.9	$264.2	$184.4	$181.0	$1,011.9	$887.5	$867.0
Cash from Ops	$291.4	$320.4	$54.5	$68.8	$758.9	$987.7	$966.7
Capital Spending	$169.1	$150.1	$161.1	$145.5	$611.1	$438.3	$693.0
Acquisitions	$0.8	$35.7	$717.9	$0.0	$204.0	$118.6	$58.2
Pymts for Business	$22.5	$17.4	$16.2	$19.1	$71.8	$75.0	$131.7
JV Investments	$0.0	$56.6	$0.0	$6.5	$78.6	$18.3	$19.2
Cap Lease Pymts	$9.7	$11.2	$10.4	$12.4	$46.1	$47.8	$58.0
+ Sale Leasebacks	$91.1	$197.3	$5.4	$12.4	$278.3	$564.7	$166.1
Free Cash flow	$180.4	$246.7	-$845.7	-$102.3	$25.6	$854.4	$172.7
Dividend	$179.8	$178.8	$184.4	$181.0	$718.3	$716.3	$704.5

Keurig Dr. Pepper Inc. (KDP)

Date Added	12/4/2020
Market Cap	$52.5 B
PE (fwd)	22.0
Short %	1.6%
Current EQ Rating	2- (Weak)

KDP’s 2Q22 non-GAAP EPS of $0.39 met forecasts. They did pick up 1.6 cents from a lower tax rate. The bigger issue to us is how much more can KDP take the price hikes it is posting. Ball Corp already said it saw sales volume weaken as citizens pushed back on buying cans of soft drinks due to higher prices.

KDP took a 10.4% increase in pricing and boosted its guidance for revenue based on higher pricing for 3Q. If they are unsuccessful in achieving 100bp of their price increase – it would cost them 2 cents in EPS.

- Payables are up to $4.95 billion from $4.5 billion in 1Q. The DSPs are 280 vs 284 reflecting inflation, but KDP is up to $3.7 billion of factored payables or 209 days. We will point out again, this factoring program had little cost for several years with short-term rates at essentially 0%. The 3-month SOFR is now 350bp. That’s a $130 million in interest cost that KDP’s suppliers are paying to let KDP keep their money for an extra 9 months. That would be 7 cents in lower annual EPS for KDP if it has to start paying those fees.

- To further put payables in perspective, KO has a similar program in place. It has $3.7 billion of payables factored also, but that represents only 72 days. KO only breaks out its payables from accrued expenses in the 10-K. So, in December, KO had $4.6 billion in payables and the total account including accrued expenses was $14.6 billion. In June, the total was $14.2 billion. Even if we estimate payables rose to $5 billion with inflation, KO’s total DSP would still be under 100 days vs. KDP at 280 days.

- Also, boosting payables is a huge part of KDP’s cash flow. In 1Q22, KDP has $663 million in cash from operations with $151 million from higher payables. In 2Q22, cash from operations was $676 million with $529 million from higher payables. This company is carrying over $15 billion in debt with the payables added in. If they must reduce payables – where is the cash coming from? Just adding the factored payables to the debt multiple of EBITDA boosts KDP’s leverage from 2.8x to 3.8x.

- We think it is also a red flag that KDP boosted pricing by 10.4% and had operating margins fall 330bp. It was also touting that supply chain bottlenecks were fixed and it saw increased productivity.

Mohawk Industries, Inc. (MHK)

Date Added	6/11/2021
Market Cap	$5.9 B
PE (fwd)	6.5
Short %	3.4%
Current EQ Rating	2- (Weak)

MHK's non-GAAP EPS of $4.41 was 12 cps ahead of the consensus target while sales came in just $5 million above estimates. However, as is typical for MHK, several unusual accounting-related benefits appear to have boosted earnings by more than the amount of the earnings beat. We have followed MHK for over a decade and regularly see signs of unusual movements in reserves and allowances that could be an indication of earnings management. It is the size and extent of the recent activity which prompts us to add MHK to our Top Risk list.

We note the following items benefitting the 6/22 quarter:

- Despite revenue rising by $200 million compared to last year's second quarter, the warranty reserve fell by almost $14 million driving the warranty reserve as a percentage of revenue down to 1.3% from the year-ago 1.9%. While we don't know what the actual warranty expense is, we estimate that it would take a charge of about 35 cps to put the reserve back at a more normal 2.2% level. We are not suggesting the 6/22 quarter benefitted by that amount as the reserve has worn down over time. In practice, the company could rebuild the reserve over time and spread the headwind out over a few quarters.

- The allowance for discounts, claims, and doubtful accounts fell to 3.7% of gross trade receivables. This percentage has been declining as the company's reserves return to a more normal level versus the pandemic spike. However, the allowance percentage is now well below its pre-pandemic range. We estimate it would take an 18-cps charge to return the allowance to a normalized level. As with the warranty reserve, rebuilding the sales allowance could be spread over multiple quarters but is still a very meaningful potential headwind.

- The amortization of capitalized costs to obtain contracts as a percentage of average capitalized balances fell to 23.3% in the latest quarter from 26.6% in the year-ago period indicating a longer effective amortization period. It seems that the more recently placed store fixtures are being amortized over a longer time frame than the older ones that are

becoming fully amortized. This does not seem like a sustainable trend. We estimate that if the amortization percentage had remained at the year-ago level of 26%, it would have taken about 1.8 cps off of EPS in the second quarter.

- Inventory DSIs in the 6/22 quarter jumped by more than 20 days versus the year-ago period. However, this was due to the company selling out of inventories during the pandemic-driven demand boom and struggling to rebuild in the wake of supply chain disruptions. Management indicated that inventories are still too low and hampering sales growth. We expect to DSIs continue to increase in the next few quarters.

Mondelez International, Inc. (MDLZ)

Date Added	12/4/2020
Market Cap	$80.8 B
PE (fwd)	20.3
Short %	1.0%
Current EQ Rating	2- (Weak)

MDLZ's non-GAAP EPS of $0.67 beat estimates by 3 cents in 2Q22. To their benefit vs. some of the other food companies, MDLZ had a 5.1% volume gain too. The company's pricing drove the beat with an 8% pricing gain and more expected in 3Q. Every 100bp of pricing added 4.2 cents. That would seem to be a decent risk here if MDLZ cannot keep accelerating price hikes.

We also see that MDLZ picked up 1.2 cents from a lower tax rate, 0.35 cents from lower stock compensation, 0.4 cents from rounding results up, and 1.3 cents from a lower share count. Buying back shares is not necessarily bad, but MDLZ is also making several acquisitions and paying a dividend. It is funding the share repurchases by drawing down cash.

- MDLZ continues to let inventory DSI's fall. That is also helping cash flow as inventory levels are not growing as fast as they may be expected to rise.

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Inventory	$3,038	$2,838	$2,708	$2,922	$2,925	$2,635
COGS	$4,518	$4,754	$4,825	$4,358	$4,011	$4,272
DSIs	61.2	53.7	51.3	61.2	66.5	56.3

MDLZ's DSIs are still declining and are 8-9 days below pre-Covid levels. That translated to about $400 million in cash flow that MDLZ has generated. Free cash flow so far this year is $1.6 billion, but MDLZ spent $1.4 billion on an acquisition, $1.6 billion on share repurchases, and $1.0 billion on dividends.

- MDLZ uses average cost accounting so new purchases into inventory start impacting Cost of Goods Sold immediately. However, older inventory purchased at lower costs also continues to impact results. It's not as powerful as FIFO under inflation, but it should be having less impact than LIFO, especially if DSIs are falling. MDLZ reported that gross margin fell 210bp in 2Q against an 8% price hike. That also poses a risk if the company cannot boost prices at a faster rate. Another potential problem is they are already taking more pricing than inflation justifies:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Price gains on Op. Inc	$532	$349	$190	$207	$130	$151
Higher costs on Op. Inc	$436	$191	$225	$179	$20	$49
Net	$96	$158	-$35	$28	$110	$102

- Latin America's inflation is also helping results. The segment is 12% of sales but produced 26% of MDLZ's total sales growth. We continue to see this as a skewed figure. The easy comps are gone for volume growth here. Also, FX hits could get much larger. For organic growth, MDLZ excludes the FX hit, but normally, those losses are the reason for the outsized pricing gain:

Latin Am	2Q22	1Q 22	4Q21	3Q 21	2Q 21	1Q 21	4Q 20
Pricing	20.6%	17.0%	15.1%	15.1%	14.9%	10.1%	6.4%
Volume	12.4%	8.7%	4.6%	10.8%	18.8%	-2.9%	-5.2%
Org. Growth	33.0%	25.7%	19.7%	25.9%	33.7%	7.2%	1.2%
FX Hit	-2.1%	-2.0%	-7.3%	-2.8%	-2.8%	-15.1%	-16.6%

Okta, Inc. (OKTA)

Date Added	9/26/2022
Market Cap	$8.6 B
PE (fwd)	Na
Short %	5.1%
Current EQ Rating	3- (Minor Concern)

OKTA reported -$0.10 in non-GAAP EPS beating forecasts by 20 cents for 2Q23. This follows 1Q23 results of -$0.34 which beat by 7 cents. About 9 cents of the 20-cent beat came from non-GAAP R&D falling to 19% from 22% y/y and sequentially. Its fiscal 2023 revenue guidance was raised only about $50,000, but it did boost non-GAAP EPS forecasts by 41 cents.

- Deferred revenue has stalled as revenue growth has continued. Deferred revenue of $996 million at the end of 4Q22 is now only $1011 million at the end of 2Q23 with quarterly revenue up $69 million.

- The lack of deferred revenue growth is impacting cash flow. Cash from operations is -$0.2 million vs. $53.5 million on a -$143 million swing in deferred revenue growth. Plus, cash flow is being helped by receivables being paid down. DSOs are down from 95 days to 65 days from 4Q.

- The company's free cash flow margin is the lowest in 10 quarters at -5.3%. It is normally a positive figure. Stock compensation falling y/y by $16.5 million accounts for some of that, but it would have still been negative.

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
T12 Free Cash Flow	$25.3	$45.7	$87.5	$114.9	$123.1	$133.8	$110.7	$96.4
T12 Stock Compensation	$654.4	$670.9	$565.5	$464.0	$361.9	$222.6	$196.2	$176.7
Stock Comp % of Free Cash Flow	2585.3%	1468.6%	646.5%	403.7%	293.9%	166.4%	177.2%	183.4%

- OKTA also appears to be the security software company that is most reliant on buying its R&D via acquisitions and adding back the amortization and not expensing the goodwill. OKTA posted a non-GAAP loss of 10 cents per share but gained 35 cents from ignoring expensing goodwill assets and adding back amortization.

- OKTA's R&D overall has some questions. Total R&D and cash-only R&D have flattened out. They still rely on a large amount of stock compensation to cover R&D. Will this continue with the stock falling? If employees want more cash, OKTA can't add that back

to non-GAAP EPS, and earnings will appear pressured too. Adding 100bp of sales to R&D would hurt EPS by about 3 cents per quarter.

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Sales	$451.8	$397.9	$383.0	$350.7	$315.5	$251.0	$234.7
R&D	$155.8	$161.7	$147.5	$130.5	$122.4	$68.9	$62.3
R&D %	34.5%	40.6%	38.5%	37.2%	38.8%	27.4%	26.5%
Stock Comp	$70.1	$69.0	$62.7	$56.6	$53.3	$20.1	$18.8
Cash R&D	$85.8	$92.6	$84.7	$74.0	$69.1	$48.8	$43.5
Cash R&D %	19.0%	24.8%	22.1%	21.1%	21.9%	19.4%	18.5%

Post (POST)

Date Added	3/30/2022
Market Cap	$5.0 B
PE (fwd)	50.9
Short %	4.8%
Current EQ Rating	3- (Minor Concern)

POST beat fiscal 3Q22 (June) EPS estimates of 55 cents by 14 cents. We saw that they cut advertising by $6.5 million to pick up 8 cents and for a company that continually makes acquisitions, it added back a catch-all of restructuring, integration, purchase price adjustments, and even something called "costs expected to be indemnified" of $6.2 million for another 7.6 cents. POST picked up $128.1 million in sales via prior acquisitions too. Margins in those units range from 4%-22%. At a 4% margin, this added 6 cents to EPS for the quarter. At a 10% margin, this added 16 cents.

- Inventory levels are still looking like a problem as DSIs continue to decline.

Inv. DSIs	4Q	3Q	2Q	1Q
fiscal 2022		41.3	45.8	46.5
fiscal 2021	42.8	55.1	56.5	53.2
fiscal 2020	56.3	61.8	49.2	54.5
fiscal 2019	53.4	52.4	54.1	46.2

POST uses FIFO accounting, which should benefit gross margins the most during inflation. It still looks like POST is trying to avoid purchasing inventory during inflation and hoping costs improve before stocks run too low. Inventory in dollar terms is actually still rising and it is cutting into cash flow as it still makes acquisitions, and the inflation impacts the inventory that is being replaced. POST said on its earnings call that it needs to build inventory before the holidays.

- What happens if POST does need to replenish stocks at higher prices? Adding 10 days of inventory would consume $125-$130 million in cash flow. For the holidays, they may need 15-20 days of inventory. Through nine months, POST's free cash flow is $27.5 million.

- POST is raising prices too as inventory levels drop – this should be creating a big tailwind for margin. It's not! Replacing inventory at higher prices may make this worse.

Segment	3Q	2Q	1Q
Post Consumer Price	9%	6%	8%
Post Consumer Vol	7%	3%	-9%
Post Consumer margin	-500bp	-500bp	-200bp
Weetabix Price	7%	8%	6%
Weetabix Vol	-6%	-2%	-4%
Weetabix margin	-100bp	flat	-200bp
Food Serv. Price	27%	10%	8%
Food Serv. Vol	6%	11%	12%
Food Serv. Margin	200bp	200bp	flat
Refrig Retail Price	9%	5%	5%
Refrig Retail Vol	4%	2%	-7%
Refrig Retail margin	-200bp	-400bp	-800bp

- Debt is $6 billion. On EBITDA guidance that is 6.4-6.5x EBITDA. The company said on the earnings call, *"We continue to aggressively pursue M&A and in the last 2 years, have completed 6 tuck-in acquisitions. We expect the volatile markets to lead to some larger opportunities."* It also has until May 2023 to close on a deal for its SPAC too – it claims to be looking still. This all sounds like more debt is possible for POST.

Sealed Air Corporation (SEE)

Date Added	12/4/2020
Market Cap	$6.6 B
PE (fwd)	11.0
Short %	1.5%
Current EQ Rating	2+ (Weak)

SEE's adjusted $1.01 in EPS beat by 5 cents in 2Q22. The company did not raise guidance on any metric following the beat. We see several areas of low-quality/non-sustainable sources for the beat:

- A lower tax rate added 1.2 cents.
- Adding back recurring 3rd party consulting fees added 2 cents.
- Lower share compensation/profit sharing added 1 cent.
- Adjusted EPS was up 22 cents y/y, SEE gained 29 cents for price increases exceeding commodity inflation plus operating cost inflation such as labor. We think that by itself more than generated the earnings beat.

There are several headwinds for SEE as well. Most notably, lower oil prices may sap its pricing power. It is supposed to have commodity inflation and deflation net out to zero over time but SEE has been ahead of its customers for some time:

- SEE managed to take $179 million in positive Price/Cost with 10-consecutive positive figures from 1Q18 – 3Q20. Here are the recent figures:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Price/Cost EBITDA	$114	$98	$36	-$18	-$36	-$18	-$7	$9

  So, from +$179 million, SEE lost back $79 million 4Q20-3Q21. It has since taken $248 million more.

- Other operating costs are supposed to be SEE's problem to deal with, not the customers. These are changes in labor, rent, etc. Looking at the EBITDA bridge of y/y growth from Price/Cost, SEE also lists operating costs the same way and often points out its prowess

of reducing costs. Even when Price/Cost was running negative for four quarters, SEE was still seeing positive gains in EBITDA from falling operating costs. Now that has become a big headwind and some of that may not decline even if Price/Cost does:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Op Cost EBITDA	-$58	-$30	-$4	$3	-$13	$10	$2	$4

The CFO already said on the call that is trying to hold guidance flat despite beats because it sees more pressure from these headwinds.

- It is seeing inventories rise much faster and are considerably higher than before Covid at this point. The problem we have with SEE is it uses FIFO accounting. If DSIs are rising at SEE, it means they are building inventories as the costs rise. However, if oil/gas chemicals that become plastic compounds decline in price – SEE will have huge inventories to sell acquired at higher costs:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Inventory	$933	$844	$726	$741	$731	$652	$597	$631
COGS	$980	$941	$1,056	$1,003	$928	$866	$917	$833
DSIs	86.6	80.7	63.2	68.0	71.7	67.8	59.9	69.7

We went back to look at 2019 and DSIs were basically 70 days except for 4Q at 60 days and seasonally, 4Q is normally lower. There are several problems we see:

- On the 2Q22 earnings call, SEE reported it is seeing customers who buy packaging products from SEE starting to adjust their inventories due to the sliding economy.

- Some of the pricing changes that SEE takes come from commodity index formulas. Those can go down also. So if volumes decline and pricing starts to retreat – SEE is loaded with higher-cost inventory. Does that work well for more big price hikes?

- Volume is already falling and look at the comps for 3Q and 4Q that are coming:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Food Vol	-2.3%	1.5%	6.2%	5.7%	4.2%	-0.4%	0.3%	-1.8%
Protective Vol	-7.6%	-3.2%	0.9%	3.8%	15.2%	13.0%	7.4%	21.4%

Sysco Corporation (SYY)

Date Added	6/11/2021
Market Cap	$37.9 B
PE (fwd)	17.9
Short %	1.8%
Current EQ Rating	3- (Minor Concern)

SYY reported non-GAAP EPS of $1.15 in its fourth fiscal quarter ended 6/22 which was 4 cps ahead of consensus estimates. Sales beat the top line target by over $600 million. However, the stock fell on guidance for fiscal 2023 which was weaker than the market was expecting.

Our main concern with SYY has always been the degree to which its results seem to regularly benefit from unusual items as well as regularly recording charges which it adds back to non-GAAP earnings. We identified several such items in the quarter which call into question the quality of the company's earnings beat.

- We noted in our review of the previous quarter that the unusual benefit the company was receiving from its artificially low adjusted provision expense has turned into a headwind. However, this unsustainable benefit returned with a vengeance in the latest quarter, adding 2.5 cps to earnings growth.

- Restructuring and Transformational Project Costs added back to non-GAAP earnings remained high at 7.7 cps. The size and seemingly arbitrary nature of the add-backs reduce the quality of adjusted earnings.

- The company added back 8.5 cps in additional Covid inventory write-downs, up from the 5.8 cps added back in the last quarter. We wonder if the company has sold some of these inventories with a reduced cost basis.

On Deck Risks

Teva Pharmaceuticals (TEVA)

We always view TEVA as a trading stock as it routinely bounces between $7-$11 multiple times each year. We will keep it as an on-deck name because of the current low price. We think TEVA continually adds back too many recurring cash costs to non-GAAP EPS and faces several other accounting-induced headwinds:

- TEVA's non-GAAP EPS is adding back its legal costs that are rising rapidly:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Legal Cost	$729	$1,124	$604	$3	$6	$104	$50	$21
NonGAAP EPS	$0.68	$0.55	$0.77	$0.59	$0.59	$0.63	$0.68	$0.58
Beat/Miss	$0.12	$0.00	$0.04	-$0.06				
Legal EPS	$0.54	$0.83	$0.45	$0.00				

  TEVA has been guiding to a 17%-18% tax rate so we just used that to estimate the amount of Non-GAAP EPS generated by adding back the legal costs. So on this one item, TEVA reported adjusted EPS of 68 cents in 2Q22 which beat forecasts by 12 cents, but it picked up 54 cents by adding back legal bills. For 1Q22, it met forecasts of 55 cents but added back 83 cents for legal costs.

- TEVA has been drawing down sales allowances for years and this is generating EPS too. We think this may be losing steam at this point and could become a bigger headwind:

	2Q22	1Q22	2021	2020	2019	2018
New Sales Allowance	$3,382	$3,088	$13,426	$14,415	$16,767	$18,899
Allowance Used	$3,309	$3,522	$14,009	$15,750	$17,319	$20,069
Net change	$73	-$434	-$583	-$1,335	-$552	-$1,170
EPS Impact	-$0.06	$0.32				
Ending Allowance	$3,880	$3,807	$4,241	$4,824	$6,159	$6,711
% Gross Sales	13.6%	13.3%	14.5%	15.5%	18.3%	18.1%
% Net Sales	25.1%	24.5%	31.6%	33.5%	36.7%	35.5%

  The declining allowance helped 1Q22 by 32 cents for both GAAP and non-GAAP. That likely set up 2Q22 to see a small headwind of 6 cents. Look at how much these allowances have declined.

We think this could still be a sizeable headwind as insurers and governments push for lower prices on drugs and TEVA may need to reload the allowance with higher offsets to sales.

- In 2Q22, the tax rate came in at 7.7% vs. guidance of 18%-19% - this added 8 cents to EPS. Cash costs for R&D (no stock compensation) fell y/y in 1Q22 and 2Q22 – adding 2 cents to each quarter. Cash costs for SG&A fell y/y in 2Q22 and added 2 cents more.

- The bull case for TEVA is it will pay down debt and essentially move more of the enterprise value to the stock price. We are pointing out that debt reduction was coming much slower than TEVA was forecasting. Now it has litigation accruals rising rapidly and debt is starting to rise again. This again points to the huge litigation charges TEVA is adding back to earnings. Those are going to cash outflows:

	2Q22	**1Q22**	**4Q21**
Legal Accrual	$3,928	$3,762	$2,710
Net Debt	$20,024	$20,742	$20,878
Total	$23,952	$24,504	$23,588
EBITDA	$1,134	$1,135	$1,373
Free Cash Flow	$301	$117	$716

Top Values

Air Lease Corporation (AL)

Date Added	9/26/2022
Market Cap	$3.5 B
PE (fwd)	
Short %	2.6%
Current EQ Rating	4+ (Acceptable)

AL's business model suffered from four external events since 2020:

- Covid grounded airplanes and airlines asked for rent deferrals – which cost AL cash revenues.

- Airbus and Boeing could not deliver new planes on time with semiconductor shortages, labor issues, and investigations into various models.

- Fewer deliveries of new planes caused AL to sell fewer used planes and cost it revenues and profits from trading.

- Russia/Ukraine led to the nationalization of some planes operating in Russia

We believe there are many signs that these problems are ending, and AL could see growing forward earnings. It is already beating forecasts. The long-term driver for growth could also come from the higher cost of capital for airlines causing many to increase the percentage of their fleet that is leased leading to AL's market expanding at a faster rate. AL can bring in $6 billion in new planes per year (vs. the $3-$4 billion in recent years) with the capacity on its balance sheet and the bulk of its debt is fixed-rate. Its $18 billion in debt rolls over about $1-$3 billion per year.

- Aircraft deliveries are improving with 33 so far in 3Q22 with another week to come:

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Aircraft Deliveries	33	21	8	15	16	12	10

AL kept 2022 delivery guidance flat at $3.5-$4.5 billion of aircraft after 2Q22, but after $0.5 billion in 1Q and $1.4 billion in 2Q, it expects $1.2 billion in 3Q. We believe, AL may beat forecasts for 3Q, and it could raise the 4Q outlook on this front.

- AL has noted on recent calls that deliveries were so slow that many airlines canceled orders to recover their cash deposits. It believes many planes are nearly completely built other than a few parts due to various supply chain issues. It sees the possibility that Boeing and Airbus may offer many of these planes for sale in the coming quarters. That could give AL more supply.

- AL normally sells planes when they reach 6-10 years of age and recycles the capital into new planes. It books gains/losses on the sales, there can be fees earned, and it also conducts sales for others for fees. The lack of new plane deliveries has almost destroyed this side of the business in the last few years. Now, AL is guiding to $750 million in total aircraft sales for the 2H of 2022. That may be 25-30 aircraft being sold:

	1H22	1H21	2021	2020	2019	2018	2017
Planes sold			3	8	30	15	31
Trading Revenue	$42.5	$12.6	$51.1	$54.8	$100.0	$48.5	$65.6

**For 2021 – we removed $34.0 million in gains from selling its Aeromexico notes and $14.0 million of gains in 2020 from repurchasing some of its floating rate debt.*

The lack of deliveries in recent years has helped asset values for used planes and normally, planes under 10 years old command a premium too. If AL has $750 million in aircraft being sold in 3Q and 4Q, this could jumpstart the trading and other income figure.

- There are interest rate-linked escalators in some of the leases that AL has with customers that could boost rent for some planes. Revenue growth could also benefit from collecting and recognizing $182 million of rent that was deferred during Covid. This was only $8.7 million in 2Q22.

- We think AL should trade close to book value of $58 vs. the current $30.11. Higher earnings would help that figure. Aircraft values on the balance sheet may be at a discount from fair market value. There are also insurance claims on the Russian planes that may boost book value. AL wrote off those aircraft and cost book value just over $5 a share in 1Q22.

- FX is an issue worth watching. AL collects rent from customers in US Dollars and aircraft and fuel are often priced in dollars too. Yet, the customers are frequently paid in local currencies so at the same time the world has seen higher commodity prices, customers may be seeing more inflation because their currencies are declining vs the dollar.

Air Products and Chemicals, Inc. (APD)

Date Added	5/12/2022
Market Cap	$52.6 B
PE (fwd)	23.0
Short %	1.1%
Current EQ Rating	4+ (Acceptable)

APD's adjusted EPS of $2.62 in fiscal 3Q22 beat estimates by 1 cent. We like that again there were no adjustments to GAAP EPS. The company had a 1.3-cent headwind from a 40bp increase in the tax rate. APD is getting some operating leverage from higher sales as SG&A and R&D rose in dollar terms, but as a percentage of sales fell by 150bp. It also added 4 cents from other income representing gains on asset sales and FX transactions. That was matched by a 4-cent loss of EPS due to lower pension income. Overall, FX was an 8-cent headwind for EPS too. Earnings and the beat look solid to us:

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

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

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

- For Merchant business, APD can see a lagging impact of costs changing faster than revenues. This commodity risk is typically short-term and APD changes pricing to offset it. The company was able to get ahead of the cost inflation in the March 2022 quarter

and again in June 2022 the rate of change for oil, gas, and various distillates and other feedstocks has slowed considerably since 2021 with oil now falling.

- APD does hedge for interest rate risk and raw materials and marks to market. Most of these changes flow through Accumulated Other Comprehensive Loss, not EPS. However, there are some positions not treated as hedges that DO IMPACT EPS – both GAAP and adjusted. We see this as non-material for 1-4 cents vs APD's $10 EPS.

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

- The expected cost for growth is another $15 billion. APD is showing it is producing about $1.5 billion per year of free cash flow after the dividend to pay for much of this and has the borrowing capacity of holding Debt at 3x EBITDA or below to pay for the rest. Debt is currently only 1x EBITDA.

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

AT&T, Inc. (T)

Date Added	3/12/2021
Market Cap	$114.1 B
PE (fwd)	6.3
Short %	1.1%
Current EQ Rating	4+ (Acceptable)

AT&T raised revenue growth forecasts at Wireless – its largest unit and two-thirds of revenue - from 3%+ to 4.5%-5.0% for 2022. Broadband revenue guidance was left at 6%+ even though the goal to reach 70 million POPs for 5G and fiber footprints by the end of 2022 was met in 2Q22. Now the goal is to reach 100 million POPs by the end of 2022. It also cut Free Cash Flow forecasts from $16 billion to $14 billion. It beat 2Q22 adjusted EPS forecasts of $0.65 beat by 3 cents. We consider that a strong beat given several headwinds that impacted results:

- Bad debt expense rose by $130 million, costing it 1.3 cents. It expects a $1 billion headwind to free cash flow due to rising receivable balances. AT&T notes the rise in DSOs is about 2 days. The company has seen this happen before in recessionary times and notes that people may be slower in paying – they do still pay to keep their phones turned on.

  It's difficult to see this with Covid because AT&T's receivables included several operating units no longer here and we know the Warner revenues were hit by the loss of movie theater and sports revenues which would skew the DSO calculation. But in 2008 and early 2009, we can see that the situation corrects itself:

	2Q09	1Q09	4Q08	3Q08	2Q08	1Q08
Revenue	$30,734	$30,571	$31,076	$31,342	$30,866	$30,744
Receivables	$14,846	$14,965	$16,047	$16,395	$15,921	$15,697
DSO	44.1	44.7	47.1	47.7	47.2	46.6

- T lost $100 million from delayed government payments along with inflationary pressures in the Business Wireline unit costing it 1 cent.

- The end of FirstNet and CAF II reimbursements were known events coming in as well as some ARPU headwinds from 3G retirement that were not quantified. AT&T said the first two were $100 million or 1 cent of lower EPS and 3G's headwind was not defined. Adjusted EPS still beat and were up y/y. Early 2022 included expenses related to turning

off 3G networks, writing off assets, removing some equipment, moving customers to new plans, or losing some. That is now over and should become a tailwind going forward as 3Q21-early 2Q22 quarters with expense and disruption compare to future periods without those issues.

- AT&T said inflation is running $1 billion above its 2022 guidance and some part of that was a headwind for 2Q22 too – every $100 million is a penny of headwind. That was not in 2Q guidance. Now, ARPUs are rising, customers are opting for more premium plans and roaming fees are starting to return. Two quarters ago, roaming fees were still basically zero and premium plan customers for wireless were only about 15% of the total so there is room for much more growth in these areas. AT&T also expects some of the government spending delays which resulted in revenue pressure at Business Wireline in the first half of 2022 to be resolved,

- The company is also boosting some prices to cover inflation pressures and there are promotional broadband plans that will roll off later this year and result in higher prices too. Simply offsetting some of the inflation should boost earnings.

- AT&T also accelerated spending to gain new customers. It is running ahead of its guidance on mobility customers and fiber broadband. Adding the new customers required more capital spending and also more marketing, customer service, and technician labor than forecast too. This was not quantified, but these were also costs that exceeded guidance for 2Q. Setting up new infrastructure and getting initial customers in new areas involves more upfront costs and costs per user. Since AT&T has already exceeded its goal of new location set-ups, it should be able to build increased usage at these existing sites at a lower cost per new user.

- AT&T expects to ultimately realize $6 billion in annual cost savings, largely related to retiring copper lines. It achieved $3 billion in savings at the end of 2021 and expects to reach $4 billion by the end of 2022. Thus far, much of these savings have been applied to new investments such as the HBO Max rollout when it owned WarnerMedia and paying for accelerating broadband, fiber, and 5G roll-outs too. AT&T noted on the earnings call that it expects to see some of those cost savings flow to the bottom line in 2H22 and beyond.

- From an earnings standpoint, interest expense should decline too. At the end of 1Q22, net debt was $169 billion. It was $132 billion at the end of 2Q22. That is $1.5 billion in

annualized tailwind from lower interest expense. The dividend is $8 billion per year and free cash flow forecast at $14 billion will allow debt to decline further.

LyondellBasell Industries N.V. (LYB)

Date Added	7/14/2021
Market Cap	$23.9 B
PE (fwd)	4.6
Short %	1.4%
Current EQ Rating	5+ (Strong)

We do not see LYB as being nearly as cyclical as the chemical industry used to be. There is long-term demand growth as more of the developing world uses more plastics. LYB continues to add new capacity to boost its earnings and cash flow. Certainly, there are price and cost movements that impact margins, but LYB remains one of the lowest-cost producers in the world. Its mid-cycle EBITDA is $8.0 billion, heading to $8.5 billion as a new plant comes online in 2023. That gives it a valuation of 4.4x EBITDA with a yield of 6.2% that is growing. It has very few adjustments to GAAP earnings – primarily Lower of Cost or Market valuation adjustments to inventory and occasional impairments.

- LYB is one of the biggest free cash flow generators we follow. The company also likes to use it to reward shareholders. It has retired 45% of its stock since 2013. It is paying a growing dividend and paid a special dividend of $5.20 per share in June amounting to $1.7 billion. With debt just over 1x EBITDA, they have the liquidity to keep doing this. The new PO/TBA plant was 99% completed in June 2022, so commissioning has begun and start-up will begin in 1Q23. This means growth capital spending should decline for a few quarters at this point and help free cash flow.

- The cost edge is due to shale gas in the US being cheaper than elsewhere in the world. LYB points to this cost edge arising when oil prices are more than 8x the price of natural gas. People can look at this ratio being lower now given the Russian/Ukraine war pushing up the price of natural gas. The bigger part of this is that much of the gas drilled in the US also produces Natural Gas Liquids like ethane, butane, and propane that become the chemical feedstocks. Ethane can be burned just like natural gas, so when gas prices increase, ethane normally rises too. The other feedstocks have been flat to down. Also, because European gas prices are much higher, their chemical plants have seen a higher cost to operate too. The Russian invasion is skewing the ratios, but the cost edge is still favoring US plants. LYB can use other sources of feedstocks beyond NGLs too and take advantage of the cheapest feedstock available.

- Higher feedstock prices also pressure marginal plants to close and new capacity is more costly to build with inflation and higher feedstocks. That should allow LYB to maintain a strong position on pricing if supply is lower.

- Adjusted EPS of $5.19 beat estimates handily by 49 cents. The only adjustment to earnings was adding back 21 cents related to a $69 million impairment to exit a polypropylene unit in Australia. There was also a headwind from a 22-cent pension charge that was not forecast and was not adjusted out of non-GAAP EPS. A French unit was down longer than anticipated for scheduled maintenance and that hurt EBITDA by $65 million, which we would estimate hurt EPS by about 15 cents.

- What suffered in 2Q were the European operations due to higher feedstock prices and the lockdowns in China causing both weaker demand there as well as other Asian plants looking for a non-China market to sell product into. China demand should recover, but LYB expects a bigger impact in 4Q than 3Q.

- Inventories remain low. We have pointed out that LYB normally carries about 55 days of inventory. It finished 2Q22 at 38 days, down from 41 days after 1Q22 and 4Q20. Some of the recent drop likely relates to falling feedstock costs at the end of the quarter and the COGS in the equation represents a period of higher costs. COGS was up 10% from 1Q while inventories rose by only 2%. That likely cost them about 3-4 days in the DSI calculation. We had concerns that boosting inventories may consume $600 million to $1 billion of cash flow. If the lower pricing holds, this may be a smaller headwind.

Mowi ASA (MHGVY)

Date Added	12/4/2021
Market Cap	$8.7 B
PE (fwd)	12.7
Short %	-
Current EQ Rating	5+ (Strong)

Mowi (MHGVY) is the largest salmon farmer in the world with 20% of the market. The dividend of 2.9% is expected to be at least 50% of earnings and the company has a history of paying special dividends as well. Net debt is only 1.5x EBITDA. Before Covid, Mowi's dividend was often over 5% of the current stock price. We believe the market is still missing the long-term potential here and only trades Mowi based on spot prices for commodity salmon and the memory of Covid lockdowns. Given its rollout of more consumer products and marketing in the US, the company may double or triple its revenues in the coming years. It's trading for only 13x EPS.

- The company's vertical integration allows it to lower its feed costs and boost the premiums it sells its fish for. The company sells much of its supply on contracts rather than spot markets. Demand growth is exceeding supply growth for 2022 and that forecast is expected to continue.

- Mowi's growth investments will allow it to boost its own supply steadily for many years and it has brand names and consumer products that allow for premium pricing. It has already doubled German consumption per capita and has just started the same plan in the US. Every 20% increase in US per capita consumption requires 110,000 more tons of farmed salmon or 5.5% of world supply. The US is starting at 1.7kg per capita for salmon consumption. China/HK is about 80,000 tons of consumption now and tripling that would only move per capita consumption to 0.3 kg/per year.

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

- Additional efforts are underway to reduce headcount, automate more of the salmon-raising process, and grow margins. Free cash flow net of maintenance and growth-oriented capital spending plus working capital growth is more than twice the dividend. The dividend is growing and yielding 3.3% now. Debt is only 1.5x EBITDA.

- Mowi trades in NOK in Norway and its ADS in the US trades in dollars. Norway produces lots of oil and the last time oil prices were well above $100, the NOK was about 5 to the dollar. Since oil fell from $100+ in 2014, the NOK has been 8.5-9.0 to the dollar, other than spiking to nearly 12 early in Covid. The NOK is currently depreciating against the dollar about 10.6 to the dollar vs. 9.5 only a month ago.

National Instruments Corporation (NATI)

Date Added	3/12/2021
Market Cap	$5.2 B
PE (fwd)	19.1
Short %	1.6%
Current EQ Rating	5+ (Strong)

NATI has been trading with semiconductor stocks on fears of Chinese lockdowns (which was a real situation in 2Q22) and a slowing economy shrinking semiconductor demand. Sentiment also points to high semiconductor backlogs indicating double and triple ordering that will be canceled in the future and sap sales growth. We think these issues are misunderstood:

- Most of NATI's products are bought by other semiconductor companies and used in their R&D process and testing procedures on their production lines. Thus, NATI's sales are less tied to end-user demand for large appliances, personal electronics, and autos and more tied to R&D spending in the industry, which is less likely to fall.

- NATI has additional exposure to other fast-growing sectors such as electric vehicles, driverless cars, and aerospace.

- NATI's goal is to avoid out-of-stock situations, which means carrying a heavy inventory load. Coming out of Covid, sales were impaired by customers taking its inventory levels down.

We see several areas where NATI may have already turned the corner and could see faster EPS growth going forward. Primarily, we expect many costs to leverage as sales recover:

- The company was still using brokers to locate some rare parts needed to complete orders last quarter. This cost NATI 400bp of gross margin. This was 9.8 cents in lost EPS for 2Q22 and the company still beat by 3 cents. Guidance is that inventory shortages are abating and NATI believes it can recover 300bp of gross margin in 2023. It is forecasting a large drop in the use of brokers for 3Q22 and forward.

- NATI was able to rebuild inventories and this should help revenue growth and start to reduce the backlog further.

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Inventory	$344	$308	$289	$237	$211	$197	$194	$210
DSIs	253.6	244.3	222.0	218.0	201.2	196.3	167.6	215.4
Product Sales	$355	$344	$377	$326	$307	$295	$328	$270
P Sales Growth	15.8%	16.5%	15.1%	20.8%	15.1%	7.7%	-1.4%	-11.6%

- Software is also becoming a larger part of total sales, which does not require inventory or parts. The transition to the Software-as-a-Service model is happening in 2022 and will hurt revenue by about $30 million this year. That is already in guidance.

- Backlog is at 8 weeks of sales or $248 million. This should start to decline in late 2022 and 2023. We believe it will become the equivalent of posting quarters with 14 weeks of sales with only 13 weeks of overhead costs. For 3Q22, NATI gave strong revenue guidance. NATI's revenue forecast is $410-$440 million and adjusted EPS of 46-60 cents vs. the $396 million and 36 cents posted in 2Q22. It also noted that supply constraints did not worsen in the quarter. It expects to see operating margin expand by at least 100bp in 2022. The 2Q China shutdowns added $40 million to backlog. Had those $40 million in sales occurred, NATI could have posted an additional 18.5 cents in EPS – so the margin leverage power is very strong here.

- Our only earnings quality issues with NATI are that it adds back amortization of acquired intangibles and stock compensation to non-GAAP EPS. Those are sizeable items. That's not a rare situation for tech companies. Rebuilding inventory hurt cash flow this year, but that may be complete.

- We think offsetting that is a case that the stock is cheap. The market sees a company at $40 and $2 in annual EPS. We think between the margin pressures that are showing signs of disappearing and backlog revenue becoming sales – a case can be made that forward EPS may be closer to $3.50-$4.00 giving it a PE of 10-11x with exposure to faster growth markets for revenue growth to accelerate.

Starwood Property Trust, Inc. (STWD)

Date Added	2/8/2022
Market Cap	$6.6 B
PE (fwd)	9.3
Short %	2.1%
Current EQ Rating	5+ (Strong)

- Higher interest rates help income. A 200bp increase in LIBOR adds about 11 cents to EPS as it has a 98% floating rate loan book. It also has LIBOR floors (now SOFR floors) on many of its loans. As rates increase and STWD breaks through the floors, STWD will capture more of the interest rate rise. New loans will have floors set at higher levels too so if rates turn back down with a recession, STWD will preserve its higher interest income.

- STWD does not rely on warehouse lending, it matches durations, it has fixed-rated debt, or uses interest caps and hedges. It emphasizes off-balance sheet financing too with securitizations and CLOs which removes mark-to-market risk. It has a low Loan-to-Value on assets and $3.8 billion in unencumbered assets it can tap for further liquidity. It has a very defensive balance sheet. Loans on real estate are at only 65% of asset value.

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

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

Texas Instruments Incorporated (TXN)

Date Added	3/12/2022
Market Cap	$147.4 B
PE (fwd)	16.9
Short %	1.8%
Current EQ Rating	5+ (Strong)

TXN remains one of the cleanest companies we follow in terms of Earnings Quality. The only adjustment it calls out for earnings is some startup costs for a new factory that is turning on soon and should vanish. The stock gets beaten up over fear of or actual Covid lockdowns in China – such as in 2Q22. It has seen backlog increase as well for orders that couldn't be fulfilled late in 2021 and early 2022. We still see some long-term growth from this source that should drive solid earnings growth:

- TXN is spending to expand FABs in the US that will increase its 300mm wafer production. By producing its own wafer, TXN can lower its costs. Also, 300mm wafers reduce unit costs for chips by another 20%. There are plants turning on in late 2022, 2023, and another in 2025 that may be expanded to include three more projects.

- Revenue is treated as the wildcard for TXN. It views R&D and overhead costs as long-term investments in the business. As new plants come online, expect depreciation to rise and become a slight headwind on margins. This may also happen as new plants turn on with full operating costs and the revenue grows from $0.

- Demand in the second quarter exceeded estimates and customers wanted all their orders despite the shutdown in China. This led to a back-loaded quarter with receivables increasing. We think the important point is TXN didn't see cancellations – which has been a fear hanging over the stock. While pointing to weakness in personal electronics, TXN still sees strong demand in all other markets. Other indications of strong demand include pricing remaining higher and that TXN still cannot rebuild its inventory to desired levels.

- Inventory finished the 2Q down 2 days despite the shutdowns enduring. Their goal is to be closer to 190 days and they are at 126:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
DSIs	126	128	118	114	113	116
Fin Goods DSIs	36	40	37	37	40	44

- We have discussed repeatedly how TXN's cost model is largely fixed for R&D and SG&A which makes revenue the wildcard. It is guiding $4.9-$5.3 billion in revenue for 3Q which should continue to leverage costs and preserve margins.

- Free cash flow suffered by $395 million in 2Q22 due to rising receivables with a back-end heavy quarter. We expect that to normalize in 3Q22 and see some of that cash released. Inventories consumed $139 million in the quarter and to the extent that TXN can push DSIs closer to 190 days, it will need another $1.1 billion in inventory that will consume more free cash flow. That is unlikely to happen all in one or even three quarters given the trouble it has had fulfilling current demand and growing inventories already. But, it should not surprise investors to see this as a continued headwind on free cash flow.

- TXN continues to target returning all free cash flow to investors in the form of dividends and share repurchases.

United Rentals, Inc. (URI)

Date Added	12/13/2021
Market Cap	$18.4 B
PE (fwd)	8.4
Short %	4.3%
Current EQ Rating	4+ (Acceptable)

URI is a business that people expect to be very cyclical. However, many construction jobs are maintenance and happen regardless of the economy. Also, by using URI's equipment, builders can preserve their own capital and have access to newer equipment to work with. Inflation improves URI's value proposition for customers renting vs. buying their own equipment. URI is also consolidating the industry and has had a very conservative (paying reasonable prices) for deals and can often consolidate locations to see some immediate cost-cutting. The stock looks inexpensive too at under 10x EPS and under 6x EBITDA. It is worth noting that two of URI's larger acquisitions were done at 6.7x and 11.0x EBITDA.

- URI beat forecasts and raised guidance for the year for revenues, EBITDA, and free cash flow – well after the FED started raising interest rates. It is worth noting that 50% of revenues come from non-construction markets such as energy production, large infrastructure, manufacturing plants, and transportation. Another 46% comes from commercial construction and remodeling.

- We believe EBITDA is not the proper measure to look at URI to evaluate how much debt it can carry. The company buys and sells rental equipment every year so that capital spending is not discretionary and is a cash drain. It was low in 2020 with Covid, but was a $2 billion outflow in 2021 and is forecast to reach that again in 2022:

	2022e	**2021**	**2020**	**2019**	**2018**
Rental Equip Bought	$3,000	$2,998	$961	$2,132	$2,106
Rental Equip Sold	$1,000	$968	$858	$831	$664
Net Spend	-$2,000	-$2,030	-$103	-$1,301	-$1,442
EBITDA	$5,500	$4,414	$3,932	$4,355	$3,863
EBITDA - CapX	$3,500	$2,384	$3,829	$3,054	$2,421
L-T Debt	$9,821	$9,685	$9,682	$11,428	$11,747
Debt/EBITDA	1.8	2.2	2.5	2.6	3.0
Debt/net EBITDA	2.8	4.1	2.5	3.7	4.9

We know EBITDA and capital spending were skewed in 2020 and 2021. We would applaud that debt levels are declining over time and both debt ratios are moving in the right direction. For an asset-heavy business, carrying debt < 3x on a modified free cash flow figure is conservative.

- Non-GAAP EPS adds back the amortization of acquired intangibles and integration/transaction costs. On the positive side, the integration costs end. Also, on amortization, URI uses short lives of 5 years for much of it and there are even some accelerated methods in use for part of it. After an acquisition, it often sees the fair market value of the acquired rental equipment is higher than the depreciated value on the books and inflation would make that a bigger issue for acquisitions. URI may see higher depreciation from this and it converts the acquisition to a similar depreciation life that URI uses. This is the other primary adjustment to non-GAAP EPS. What we like is URI uses a short depreciation life and looks to recycle this equipment over a few years. So this situation doesn't last forever and they are expensing this purchase item rather than putting it into goodwill. Overall, these adjustments can be seen as non-cash (other than the purchase price of the deal to begin with) and it's not as though these items are half of URI's non-GAAP earnings:

EPS Impacts	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
GAAP EPS	$6.90	$5.05	$6.61	$5.63	$4.02	$2.80
Merger costs	$0.00	$0.00	$0.00	$0.00	$0.03	$0.00
Amortiz Intang	$0.45	$0.52	$0.47	$0.53	$0.48	$0.50
Acq Dep Life chg	$0.26	$0.10	$0.13	$0.01	$0.01	$0.02
FMV of Acq Equip.	$0.05	$0.06	$0.10	$0.08	$0.08	$0.12
Non-GAAP EPS	$7.86	$5.73	$7.39	$6.58	$4.66	$3.45

There are some other non-GAAP add-backs for items like refinancing debt. Non-GAAP EPS is forecast at over $31 this year. There is essentially $2 in amortization being added back. The two depreciation and fair market value mark-up-related items are less than $1 and are likely to decline rapidly.

On Deck Values

Ball Corporation (BALL)

Since late January, BALL has lost almost 45% of its value - and this is no tech stock. In the same timeframe, the industrial sector index is down by only about 13%. A lot of fluff has come out of the valuation. However, BALL is still a leading provider in the typically stable market for aluminum beverage cans and it should see that market grow more quickly than in the pre-2015 period as aluminum increases its penetration in the packaging market driven by environmental concerns. At these more reasonable valuations, it becomes very worthy of consideration as a potential long.

Positives

- The company is standing behind its forecast for 4-6% long-term growth in worldwide demand for cans despite the slowdown in North America. It was unclear on the call if it expected an increase in international volume to make up for lower North American growth. Regardless, management pointed out that up until 2019, the company's 20-year growth rate was 1%, so the global volume growth in the quarter of 3.3% was hardly a disaster. It remains to be seen if the 4-6% growth forecast proves true, but the idea that investors can expect a mix shift towards aluminum packaging to drive growth well above the historical norm for several years seems reasonable.

- Margins should see some relief in upcoming quarters as the company's contractual price escalators based on PPI begin to take effect to help offset more of its cost inflation.

- BALL announced last week that it has successfully sold its Russian operations for $530 million. This will help its short-term cash flow challenges.

Negatives

- Our concern with BALL all along has been the degree to which the company was financing its expansion through increasing the factoring of receivables and extending payables. Factored receivables did increase in the 6/22 quarter which helped cash flow growth.

However, the pace has slowed, and given the increase in interest rates, this could very well reverse on the company as a source of cash flow growth. Likewise, the growth in accounts payables has slowed which will also dampen cash flow growth. The company has already cut capital spending plans to help free cash flow and it still plans to return $1 billion to shareholders in 2022. This seems to rule out a dividend cut this year and still allows for buybacks, albeit at a slower pace.

- Depreciation showed an unusual decline in the quarter despite an increase in depreciable assets. Just the sequential decline added about 2.7 cps to EPS in the quarter. However, a decline in depreciation expense as a percentage of assets in service seems to indicate that the company is depreciating new assets over a longer time frame than its older assets. If depreciation expense increased to the same percentage rate as it was in 2019, it would result in EPS being about 6% lower than reported.

- Management seems to have lost some credibility with the seemingly unexpected drop in demand. Investors should not forget how quickly the company's narrative went from emphasizing its inability to make enough cans to satisfy demand in North America to its recent slashing of sales forecasts and shuttering of production facilities in North America.

DocuSign, Inc. (DOCU)

We still think DOCU has some solid longer-term potential, but it is still working its way through a tougher post-Covid period. It is rebuilding some of its operating model on the fly, looking for areas to spend more efficiently, enhancing its employee training, and bringing in a new CEO and new senior managers. Our view remains that DOCU's longer-term goals of $5 billion in sales and a non-GAAP operating margin of 20%-25% still look achievable. We say that because it's already doing sales of about half that figure, existing customers continue to expand their usage with DOCU products, and it has already had periods of reaching a 20% non-GAAP margin. However, the efforts to grow more and focus on expenses and skills will take more than one-quarter to fully put in place.

- DOCU's fiscal 2Q23 non-GAAP EPS of $0.44 beat by 2 cents. That came after reducing guidance with 1Q23 results and the CEO leaving. The company boosted guidance a bit for billings and subscription revenues. We think the market was too tough on 1Q results and is giving too much praise for 2Q EPS. We think 2Q results were not a quality beat as it enjoyed higher stock compensation that was added back to non-GAAP earnings, which allowed for 2Q to hit the high point of margin guidance of 18.0%.

	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Sales	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1
Stock Comp	$141.2	$110.7	$118.0	$109.4	$100.0	$81.1
Taxes on Exercise	$3.4	$5.1	$4.2	$10.1	$11.6	$16.3
Total	$144.6	$115.8	$122.2	$119.5	$111.5	$97.4
% of Sales	23.2%	19.7%	21.0%	21.9%	21.8%	20.8%
Stock Comp %	22.7%	18.8%	20.3%	20.1%	19.5%	17.3%

Tax benefits are down as fewer employees exercise stock awards, but look at how much gross stock compensation rose. It was up 320bp y/y and 390bp sequentially. 1Q23 was probably too low, but this is commonly about 20%. Every 100bp of additional wages added back as stock compensation adds 2.4-cents to quarterly EPS. DOCU beat by 2 cents and arguably picked up as much as 7 cents in this area.

- DOCU had some sizeable employee turnover in the last year. We are applauding that headcount is rising again. We also applaud that they are ramping up training programs which should help longer-term with sales and retaining employees.

	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21	1/31/21	10/31/20
Headcount	8,061	7,642	7,461	7,056	6,551	6,080	5,630	5,364

We would expect this to pressure margins in the near term until the new employees start to close deals, but that should provide more operating leverage in 2023.

- The new employees and training could also help DOCU grow its deferred revenues more going forward. That helps cash flow too. Deferred revenues are still high, but we noticed they are not growing at the same rate as in the past.

	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21	1/31/21	10/31/20
Sales	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1	$430.9	$382.9
Deferred Rev	$1,094.9	$1,074.5	$1,049.1	$961.2	$939.8	$857.9	$800.9	$702.7
DSO	161.9	162.4	166.2	162.1	169.0	162.8	171.0	168.8

- DOCU is still reporting that existing clients are renewing for larger deals y/y. That is the result of adding new users/departments and adding new features. We think that will ultimately help drive more operating leverage and boost DOCU's margins.

OTIS Worldwide Corporation (OTIS)

OTIS reduced guidance after 2Q22 results which beat by 7 cents. The beat included a 500bp decline in tax rate y/y which added 6 cents and share repurchases added 2 cents more. OTIS has been working to lower its tax rate but expects a 26.5% rate for the year vs. 22.4% in 2Q22. It still is targeting a goal of 25%-27% - so the tailwind in 2Q22 seems unlikely to recur. Adjustments to non-GAAP EPS were adding back restructuring charges and writing off Russian assets.

The company cut the sales growth forecast by 50bp due to weaker new equipment sales. It cut EPS forecasts from $3.22-$3.27 to $3.17-$3.21. It did boost its share repurchase plan from $500 million to $700 million.

- There is an interesting long-term growth story here. About 80% of the sales are recurring service/maintenance and upgrading/modernizing existing elevators and escalators with the other 20% related to new construction. Some upgrades can be postponed but the service/maintenance cannot. Service revenue is seeing mid-single-digit growth on a total sales base of about $14.5 billion (up 5.5% before FX in 2Q22). The goal is also to streamline costs and boost margins from 14% to 20% with about 30-50bp of improvement per year. Much of that will come from digital diagnosis which reduces travel and the number of visits for service and repairs. Staff is lower overall and there are signs of improvement already with margins up to 15.8% a 30bp gain.

- We're keeping this an On-Deck Buy as it does get half its new construction spending from China (down mid-teens in 2Q22). Also, exposure to other markets in the world for even maintenance is creating problems such as its small Russian business. New construction also gets hurt when interest rates increase and Covid still has many buildings around the world not fully occupied as many employees continue to work at home. Even growing businesses may be seeing less demand for real estate as they have fewer people in the office full-time. The new construction market could be constrained and provide headline risk for the stock. New equipment sales were up 5.5% before FX in 2Q22, but this is where OTIS cut guidance.

- The company is retiring debt - $500 million YTD. Debt is only 2.3x EBITDA and OTIS wants to continue bringing that down and pay a dividend of 40% of earnings. The yield is 1.8% and growing at 20%. We like that restructuring costs are low vs. the benefit – it's not spending $2 billion to cut annual costs by $250 million. This was designed to save

$650 million (largely through lower wages) and is only costing about $50-$70 million per year for four years. OTIS still saw 30bp of margin gain in 1Q22 and 2Q22. It needs to grow into its valuation which is currently 20x EPS and just under 14x EBITDA. EPS is $3.20 and every 50bp of margin gain adds 12-13 cents to EPS. OTIS thinks it has 400bp of margin improvement to come which would make EPS $4.20 without revenue growth. Repurchasing shares should help that further.

- We think the risks of percentage completion are low given that it only impacts new construction, and most sales are completed within 12 months. Having recognition of revenue pulled forward or delayed only moves the EPS by a few cents vs. EPS of $3.20 in 2022.

The Scotts Miracle-Gro Company (SMG)

SMG is very forthcoming about making a huge mistake in overproducing inventories. No one could foresee the huge spike in demand for home landscaping and gardening supplies that was driven by the pandemic. Heading into 2022, the company remained confident in its expectations for many consumers to stick with their newfound gardening hobby and for millennial homebuyers to continue investing in their homes. Accordingly, the company invested heavily in rebuilding its inventories, determined to not miss sales in the 2022 gardening/landscaping season. Rainy weather through late spring delayed sales from materializing but management was still optimistic heading into the June quarter. However, retailers spooked by slowing consumer spending unexpectedly canceled orders, leaving SMG with a massively overbuilt inventory.

However, SMG's position in lawn and garden supplies is rock solid. The company is now forecasting FY2022 EPS of $4.00-4.20. Before the pandemic, the company earned non-GAAP EPS of $4.47 in FY 2019 and was looking for $4.95-$5.15 in FY 2020. The mid-point of that range implies a PE of 10. Given the seasonality of SMG's business, the inventory situation will not have a chance to resolve itself until next spring. Until then, SMG may remain dead money. However, the 5% dividend yield pays investors to wait. Risks remain, but we believe the company is worthy of consideration here.

Positives

- SMG's inventory poses an obvious cash flow problem but on the bright side, it will not spoil and the company plans to sell it next spring with no discounts.

- The disappointing sales appear to be more related to cautious retailers letting their inventories dwindle rather than a loss of consumer interest as end-used demand reportedly remained near record levels in May and June. Even if the economy slows and the housing market crashes, demand could prove to be resilient as homeowners often turn to investing in their own homes in slow times.

- The CEO and other officers are members of the Hagedorn family, heirs of the inventor of Miracle-Gro. The family owns 26% of the outstanding shares indicating a shared interest with investors and likely an affinity for the dividend.

Negatives

- The key risk is the debt. The company ended the quarter with debt/EBITDA of 5.1. After the quarter, the company revised its outlook for FY22 free cash flow to a deficit of $275-$325 million. This was down from a previous estimate of a $150 million deficit with the decrease being a result of lower payables. It amended its credit agreements to allow debt to EBITDA of up to 6.5 and the lower cash flow estimate came with a warning that the ratio could hit 6 at the end of the year. Cash on hand at the end of the June quarter was $28 million. The company has shut down and consolidated distribution centers and conducted layoffs to save expenses. The bulk of its revenue hits in the first half of the calendar year. Cash flow is typically negative in the September and January quarters although cash spending on inventory will be muted this time around. The company should be able to last until cash flow hits in the March 2023 quarter and be fine as long as it can sell off its inventory at reasonable prices. However, it has little cushion in the event of another 'black swan" event.

- The CFO left. While always worth paying attention to, we are not concerned this is a sign of malfeasance.

- The Hawthorne business is one of the key overhangs in our minds. Its main customer is the cannabis industry which has proven to be extremely volatile. It has experienced times of dramatic growth during spikes in legalization activity as well as unexpected weakness from oversupply as has been the case in the last few quarters. The stigma of the industry also keeps some investors from participating. However, a sale has not been ruled out and could potentially be a positive catalyst if the right deal comes along.

Warner Bros. Discovery, Inc. (WBD)

WBD is going through several operating changes to the company following the merger. Management reduced 2022 guidance to $9.0-$9.5 billion in EBITDA and pointed to 2023 as at least $12 billion. They have indicated that cost savings plans for $3 billion may exceed that target as they are seeing more opportunities than originally forecast. The expected improvement in 2023 and thereafter makes the valuation look attractive in our view. It will apply much of its free cash flow to debt retirement and should have that reduced to $38-$39 billion by the end of 2023. That would give it a debt/EBITDA of 3.2-3.3x based on the $12 billion in EBITDA. The current market cap is $27.6 billion plus the future level of debt of $39 billion for an enterprise value of $66.6 billion or 5.6 times 2023's EBITDA. Netflix trades for 17x EBITDA and Warner's assets have traded hands for 10-12x EBITDA in past sales.

- WBD kept its debt reduction guidance of being at 3x EBITDA or below by mid-2024 or sooner. That is the same plan from April 2021 despite two reductions in EBITDA guidance. And, the plan to achieve it is well-defined.

- Many of the changes WBD is now planning for the business will lead to lost revenue in 2022 but should stimulate revenue growth going forward. Yet, guidance is for 2022 to suffer revenue and cost hits and 2023 will see cost savings produce the growth in EBITDA. 2023 guidance looks light to us if some of the revenue bounces back too. We saw multiple points in its plans that will focus on revenue. For example, AT&T was limiting some content distribution and making it exclusive to HBO Max. This cost the company high margin revenue as the content costs would be flat. Also, given that HBO Max was starting out, its revenue stream may have been lighter than what other existing platforms may have paid. WBD is ending this policy and should see additional revenues if it places content on TNT and Sky too. Plus the content costs shouldn't change. Some of the revenue being lost in 2022 are TV and movie projects that WBD is cancelling, but their release was originally built into 2022 forecast. In 2023, the pipeline should be rebuilt and there should be more content released that produces revenues. WBD is getting higher ad rates and there should be some price hikes for HBO Max too as discounted deals roll over. We believe WBD could surprise on the upside in 2023 due to some stronger revenue.

- Streaming for HBO Max should also create earnings growth in our view. Losses are expected to peak in 2022 and decline toward break-even by 2024 and $1 billion in EBITDA in 2025. WBD sees this as a 20% margin business in the future. Guidance is

essentially taking $9.0-$9.5 billion in EBITDA for 2022 and adding $3 billion of cost-cutting to get to $12 billion in 2023.

- WBD is guiding to longer-term margin improvements as it reaches economies of scale with streaming and the incremental subscribers come onboard at margins of as much as 50%. Having content sold on more platforms should also leverage fixed costs more. Management is looking to add more distribution deals.

- The accounting policies look conservative. WBD gets high marks for not assigning the bulk of the purchase price to Goodwill. The expensing of new content costs is done on an accelerated basis and appears to match norms and be conservative. Discovery uses a straight-line or accelerated method for each project that will expense it over a maximum of 10 years. However, in reality, over 90% is amortized by the third year. Time Warner before AT&T used the same method and also pointed to over 90% of content costs being amortized by the third year. Sales commissions are largely expensed as incurred or in under one year. We see companies that capitalize and amortize this expense over as long as five years. Capitalized software is amortized over 2-5 years. That used to be the gold-standard rate in our view, but most companies we follow have moved to 3-7 years or 5-7 years. Time Warner before AT&T was using 3-7 years. Discovery stayed more conservative. Depreciation for Broadcasting equipment, furnishings, and fixtures is over 3-5 years. That is the bulk of PP&E. Again 5-10 years is more common and Time Warner was 3-10, so Discovery is staying more conservative.

Explanation of EQ Rating Scale

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

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

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

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

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

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

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

Key Points to Understand About the EQ Score

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

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

Disclosure

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