BEHIND THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers 4Q '21 Focus List

Top Sells

Company	EQ Rating	Date Added
Altria Group (MO)	2- (Weak)	6/11/2021
Conagra Brands,	2- (Weak)	10/8/2021
Equinix, Inc. (EQIX)	3- (Minor Concern)	4/30/2021
International Business Machines Corporation (IBM)	2- (Weak)	3/12/2021
Iron Mountain Incorporated (IRM)	1- (Strong Concern)	12/4/2020
Keurig Dr Pepper Inc. (KDP)	2- (Weak)	12/4/2020
Kimberly-Clark Corporation (KMB)	2- (Weak)	12/13/2021
Mondelez International, Inc. (MDLZ)	2- (Weak)	12/4/2020
Sysco Corporation (SYY)	3- (Minor Concern)	6/11/2021
Sealed Air Corporation (SEE)	2+ (Weak)	12/4/2020
TransDigm Group Incorporated (TDG)	2+ (Weak)	3/12/2021

On Deck Sells

Company	EQ Rating	Date Added
Ball Corporation (BLL)	3- (Minor Concern)	3/12/2021
Eaton Corp. (ETN)	3- (Minor Concern)	9/9/2021
Kendryl Holdings, Inc. (KD)	na	12/13/2021
Patterson Companies, Inc. (PDCO)	3- (Minor Concern)	12/13/2021
Mohawk Industries, Inc. (MHK)	3- (Minor Concern)	9/16/2021
Stanley Black and Decker, Inc. (SWK)	3- (Minor Concern)	11/30/2021
Teva Pharmaceuticals Industries Ltd. (TEVA)	3- (Minor Concern)	12/13/2021

Top Buys

Company	EQ Rating	Date Added
Air Lease Corporation (AL)	4+ (Acceptable)	12/4/2021
AT&T Inc.(T)	4+ (Acceptable)	3/12/2021
Mowi ASA (MHGVY)	*4+ (Acceptable)*	12/4/2021
LyondellBasell Industries N.V. (LYB)	*5+ (Strong)*	7/14/2021
National Instruments Corporation (NATI)	*5+ (Strong)*	3/12/2021
Texas Instruments Incorporated (TXN)	*5+ (Strong)*	3/12/2021
UnitedHealth Group Incorporated (UNH)	*5+ (Strong)*	3/12/2021
United Rentals, Inc. (URI)	*4+ (Acceptable)*	12/13/2021

On Deck Buys

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

Summary of Changes to the 4Q'21 BTN Focus List During the Quarter

Added to Top Sells

Conagra Brands, Inc. (CAG)	Added 10/8/2021
Kimberly-Clark Corporation (KMB)	Added 12/13/2021

Removed from Top Sells

Patterson Companies, Inc. (PDCO)	Removed 12/13/2021

Added to On Deck Sells

Eaton Corp. (ETN)	Added 9/9/2021
Kendryl Holdings, Inc. (KD)	Added 12/13/2021
Patterson Companies, Inc. (PDCO)	Added 12/13/2021
Stanley Black & Decker, Inc. (SWK)	Added 11/30/2021
Teva Pharmaceuticals Industries Ltd (TEVA)	Added 12/13/2021

Removed from On Deck Sells

Conagra Brands, Inc. (CAG)	Removed 10/8/2021 (added to Top Sell)
Kimberly-Clark Corporation (KMB)	Removed 12/13/2021 (added to Top Sell)
TreeHouse Foods, Inc. (THS)	Removed 12/13/2021

Added to Top Buys

United Rentals, Inc (URI)	Added 12/13/2021

Added to On Deck Buys

Lamb Weston Holdings (LW)	Added 10/12/2021

Overview of the BTN Focus List

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

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

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

Top Sells

Altria Group, Inc (MO)- Top Sell

Date Added	6/11/2021
Market Cap	$82.8 B
Target Price	$35
PE (fwd)	9.8
Short %	0.6%
Current EQ Rating	2- (Weak)

How the Bulls See It:

MO is seen as a safe staple and a cash cow with a sustainable yield.

Our Concerns:

- We see MO as one of the key beneficiaries of the pandemic as customers who worked from home were free of office smoking bans, train commutes, and airline travel and could therefore smoke more often. Last year, customers bought far less gasoline at $25 per barrel oil. Going forward, there will be less disposable income to spend on smoking. The decay rate for smoking is already back to -7%, where it was for years before Covid.

y/y chg in Cig Vol	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20
Altria	-7.0%	-4.5%	-3.5%	-1.0%	-1.0%	-2.0%
Industry	-6.5%	-5.0%	-2.0%	0.5%	1.0%	0.0%

- Smoking remains 90% of operating income (89% in 3Q21) and MO has sought to offset the volume decay with price increases and that plan continues. The red flag is smoking operating income just declined y/y despite less promotional spending and price hikes.

- Two potential catalysts for MO are on hold. It had been rolling out Philip Morris's heated tobacco product IQOS to replace cigarettes. The US Trade authority determined that the IQOS product violates patents held by British American and the Biden Administration did not step in to reverse that decision so MO cannot sell the product now. It was rumored that PM and MO would merge with that deal and now PM has announced it has no intention of merging.

- Smoking faces pressure from a potential menthol ban that the FDA is actively considering. Menthol has been the strongest category of cigarette sales. It will also see the roll-out of graphic depictions of smoking's harmful effects on cigarette packaging in the fall of 2022. That has already happened in dozens of countries and the impact was universal in a gap down in cigarette volumes.

- Free cash flow is $7.5-$8.0 billion at this point with a dividend of $6.7 billion (84%-89%). However, MO is also promising more share repurchases. The sale of its Ste. Michelle wine unit will cover some of that – then what? Debt is already $25 billion – probably 2.4-2.5x non-Covid EBITDA.

- Also hurting cash flow going forward is litigation. Court cases largely stalled with Covid and are returning now. Accruals in this area almost tripled YTD in 2021 vs. 2020 ($99 million vs. $34 million). If any of the discussion about raising corporate taxes happens, MO could also face a cash flow issue. Its cash flow is already about $1 billion higher due to the Trump tax cuts in 2017. Every 1% increase in tax rates would cost MO roughly $100 million in free cash flow. Plus, with smoking rates declining – that is costing it cash flow going forward too. There already is very little cushion on the dividend let alone share repurchases.

- MO already missed 3Q21 forecasts by 4-cents, even after pension expense became a credit and added 2.6-cents. MO didn't even EPS raise guidance after announcing its new share repurchase plan.

Conagra Brands, Inc. (CAG)- Top Sell

Date Added	10/8/2021
Market Cap	$15.4 B
Target Price	$27
PE (fwd)	13.2
Short %	2.1%
Current EQ Rating	2- (Minor Concern)

We bumped CAG down to On Deck Sell from Top Sell on 7/14/2021 following the price drop after 6/21 earnings. However, the company's 9/21 earnings were ugly, prompting us to move CAG back to the Top Sell list on 10/8/2021.

- With Covid demand now gone, CAG is cherry-picking how it displays its results by showing growth rates against two years ago. Investors should remember that two years ago CAG's results looked like it had been at the Somme in 1916 after digesting its Pinnacle Foods deal. It was emphasizing "Value over Volume" at that time and its volume growth vanished and inventory was stacking up. Management was expecting to require two years to fix these problems:

	1Q22	1Q21	1Q20	1Q19	1Q18	1Q17
CAG Vol Change	-2.00%	10.90%	-2.50%	0.00%	-5.30%	
Index from 2017	100.3	102.4	92.3	94.7	94.7	100
Inv. DSIs	90.1	77.1	92.8	76.1	75.9	76.7

- Covid allowed CAG to clear the shelves of its older products without markdowns or promotions. Moving forward, CAG will need to live in the real world again where Mondelez, Del Monte, Pillsbury, Swanson's, Weight Watcher's, and numerous store brands want the shelf space too and grocers aren't out of inventory. However, its recent results look like they are back to the same old rut. Pricing is up, but margins are down compared to pre-Covid's ugly results and inventory levels already look inflated. Remember CAG is a serial restructurer and recent margin results come after years of culling low-margin SKUs, divesting lower-margin units, and cleaning up inventory:

	1Q22	1Q21	1Q20	1Q19	1Q18	1Q17
CAG price chg	1.6%	4.1%	0.8%	1.2%	2.3%	
Index of price	110.4	108.6	104.4	103.5	102.3	100.0
Adj. oper margin	14.1%	20.2%	15.7%	14.6%	15.4%	

- Lower promotional spending has been a large part of profit improvement during Covid. Promotional spending is netted against sales. We know in 2Q21 and 3Q21 that half the pricing gains were due solely to lower y/y promotional spending and CAG said that helped 4Q21 too. They now have very tough comps in that area and in 1Q22 the pricing gains dropped significantly. CAG is guiding that it will continue to pay less on promotional spending forever and thus there won't be a headwind on pricing from a return of normal promotional activity. History indicates this is an unrealistic expectation.

- CAG continually takes impairments on its brands. Could there have been a stronger period for sales than in fiscal 2021? Yet, CAG took a $95.5 million brand impairment. During fiscal 2020, the impairment was $260 million, 2019 - $94 million, 2018 - $15 million, 2017 - $343 million.
- CAG is now reporting EPS is beating forecasts based on positive FX (which other companies are now forecasting to turn to headwinds), higher pension income, and rounding. It is also seeing better results from its remaining share of the lower-margin milling operations it spun off years ago into a JV (and restructured) so it could claim management improved profitability at CAG by 400bp.

- Watch out for foodservice headwinds too. Normally, foodservice has about half the margin of retail sales. Covid moved about 3% of total sales from foodservice to retail. That is now switching back at half the margin. This is about 5-cents in EPS headwind potential.

Equinix, Inc. (EQIX)- Top Sell

Date Added	4/30/2021
Market Cap	$71.8 B
Target Price	$450
P/FFO (fwd)	45.8
Short %	1.5%
Current EQ Rating	3- (Minor Concern)

How the Bulls See It:

EQIX is a liquid play on the demand for data centers offering 8% top-line growth and a small but rapidly growing dividend.

Our Concerns:

- EQIX is not self-funding. It routinely runs a free cash flow deficit of $1.3-$2.0 billion after funding all its growth areas for capital spending and acquisitions. It still has a dividend of $1.0 billion more to pay. YTD 21, free cash flow was -$632 million and the dividend was $783 million. EQIX covered the negative cash situation by borrowing and issuing more stock for a total of $2 billion.

- The company is continually issuing more shares to pay employees (with stock compensation up 24% YTD), to fund acquisitions, and simply to fund other operations. In 3Q21, recurring revenue growth without acquisitions was 3% and YTD it was 4%. The dividend outlay grew 10% YTD and the share count grew 2.6%. This has been a slow year as EQIX borrowed more and the share count often rises 6% annually.

- Finance leases overinflate REIT figures- AFFO would fall by over 7% if the principal portion of leases was not excluded. AFFO figures are also inflated by excluding stock comp (14%) and maintenance capex looks light at only 1.0% of net PPE with considerable tech-related assets. EQIX is reporting AFFO of $20.92 YTD. If we adjust for just those items and triple the maintenance spending – AFFO would fall to $14.02. That's one-third of AFFO gone by accounting for some obvious recurring costs.

- Amortizable lives appear long which increases the risk of write-downs.

- Data Centers are a hot investment area now and EQIX is posting growth. We do not see a clear near-term catalyst to cause the stock to drop. However, we believe when the market digests the fact that the company is not self-funding, the degree of dilution it is incurring to fund growth, and that the dividend is outgrowing the organic growth rate, the stock price could be more than cut in half.

International Business Machines Corporation (IBM)- Top Sell

Date Added	3/12/2021
Market Cap	$111.3 B
Target Price	$104
PE (fwd)	12.3
Short %	2.6%
Current EQ Rating	2- (Weak)

How the Bulls See It:

Bulls believe that after decades of restructuring, IBM has finally found a way to grow profitably. Its 2019 acquisition of Red Hat is expected to help it become a major force in the hybrid cloud space.

Our Concerns:

After decades of restructuring, the company's returns are substantially lower. Large, never-ending charges and non-operational benefits erode the quality of reported profit growth.

IBM is down over 15% since reporting results for the 9/21 quarter, but we believe further downside remains as the quality of earnings remains very suspect in our view. EPS beat estimates by a penny but we noted several non-operational and unexpected benefits to the quarter.

- IBM guided to a 17% tax rate but it came in at 4.8%. Even after adjusting for the tax impact of the separation of Kyndryl, the lower tax rate added 6 cps to earnings.

- Lower bad debt expense added 1.6 cps.

- Lower hedging costs added 6.2 cps.

- Lower advertising costs added 1.1 cps.

- The company reported workforce rebalancing costs of $0 for the quarter after 15 years of regularly recording material charges (which were not added back to non-GAAP results). These charges have been unusually low though all of 2021 and we suspect that the company loaded these costs into the huge $2 billion charge it took in the 12/20 quarter which was added back to non-GAAP results. Going forward, we would not be surprised to see these charges return to the $100-$200 million range adding 10-20 cps heading to upcoming results.

Iron Mountain Incorporated (IRM)- Top Sell

Date Added	12/4/2021
Market Cap	$14.0 B
Target Price	$18
P/FFO (fwd)	17.5
Short %	10.3%
Current EQ Rating	1- (Strong)

How the Bulls See It:

IRM is seen by bulls as a beneficiary of the growth in data centers. Its 5%+ dividend yield is attractive to some and the dividend at only 72% of AFFO which appears well-covered at first glance.

- IRM posted 3Q21 adjusted FFO of $0.72, which beat forecasts by 9-cents. We would note again that under the recently changed definition of FFO used by IRM – it picked up 4.3-cents from adding back stock option expense. By not factoring in the principal payments on financing leases, IRM added another 4.0-cents, and it rounded up results by 0.4 cents.

- AFFO adjusted for the cash costs still does not cover the dividend. AFFO as defined by IRM adds back the amortization of all the recurring cash costs, all the depreciation, restructuring costs, and deducts a maintenance capital spending figure. By this accounting, the dividend is only 72% of AFFO so far in 2021. However, in reality, we do not think it can cover the dividend at all. We started with IRM's AFFO with all amortization added back less maintenance capital spending, then we subtracted actual cash expenses for acquiring new business, principal payments on financing leases, and recurring stock compensation. The result is the dividend is 139% of AFFO less these recurring items.

- IRM's dividend is getting a one-time cash infusion from the company doing sale-leasebacks on property. This added $215 million in 2021 and $117 million in 2020 during the first 9 months of each year. In 2021, it also divested an investment for another $214 million. The sale-leaseback deals come with rising future lease expense too that is growing faster than IRM's storage business that is paying for it – 14% lease growth against 2% storage growth.

- IRM is touting that storage volumes grew. However, all the growth was acquired. Since last year, volumes are up 9,000 cubic feet and acquisitions added 16,000 indicating negative core growth. The accounting for acquisitions ignores many of the costs put into goodwill and the higher depreciation expense is added back to the REIT stats. Had IRM built organically, depreciation would likely not have grown much, but it would have incurred fulfillment costs and customer inducement costs – acquisitions avoid those expenses. We still expect those cash costs to rise going forward as normal business operations fully resume.

- Project Summit spending quality continues to be troublesome. Normally a restructuring program sees heavier charges early in the process and tend to decline noticeably as the process winds down. With IRM, the 8th quarter of the process, 3Q21, saw spending accelerate. Based on forecasts of $450 million in total spending, it may rise even more in 4Q21 and the program is still expected to largely wrap up by the end of 2021. We also question why severance is considered the number one cost of this plan but is only 22% of the spending. Plus, why is severance still happening? Wouldn't Covid have been the most opportune time to lay people off?

Keurig Dr Pepper Incorporated (KDP)- Top Sell

Date Added	12/4/2021
Market Cap	$50.1 B
Target Price	$27
PE (fwd)	22.1
Short %	2.0%
Current EQ Rating	2- (Weak)

How the Bulls See It:

KDP is deleveraging, its sells at a discount to other major soft drink/beverage companies, and its Keurig business gives it exposure to the growing at-home coffee market. Selling brewing machines helps coffee sales growth

Our Concerns:

- KDP touts its debt reduction efforts, but a closer look reveals the company is simply moving debt to unorthodox short-term financing instruments. One example is the company's accounts payable factoring program which has resulted in payables days climbing to 262 in 3Q21 with $3.0 billion being factored receivables. The structured payables account is back to $142 million. Headline debt/adjusted EBITDA jumps from 3.2x to 4.0x by just including these payables.

- Sale leasebacks are adding to future cash costs that will hurt EBITDA going forward, but the proceeds were used to reduce debt. Now lease costs are rising at 16% and sales growth is less than 8% with price hikes happening.

- KDP cut marketing by $200mm in 2020. In 1H21, it had been reporting higher marketing in just its two smallest units. In 3Q21, KDP is saying marketing rose in all units. That tailwind for EPS is likely now a headwind.

- Coffee sales received a boost from higher equipment sales during the pandemic and a new product release. Sales of brewers rose 61% in 1Q21, 29% in 2Q21, and only 2% in 3Q21. Coffee sales growth had been exceeding pod growth too. In 3Q, coffee sale growth of 5.3% lagged pod growth of 6.3%.

- Commodity exposure and higher marketing hurt the three top operating segments. Only Latin America showed a higher adjusted operating margin and that was driven by FX gains in addition to price hikes. We have talked about this repeatedly, KDP is aggressively pricing to offset FX losses in the region. In 2020, the FX losses were so large that 2021 saw a rebound. This carried the operating margin up for the region by 350bp in 3Q21. Pricing was up 4% with FX up another 11.3%. Other companies are starting to see FX gains like this reverse and are lowering forecasts.

- Overall, KDP beat forecasts by 2-cents in 3Q21 but did not raise guidance on EPS. We think 1-cent of EPS in the quarter came from the FX situation in Latin America that does not seem sustainable. The restructuring charges (which KDP adds back to adjusted EPS) rose in 3Q by $14 million and added about 1-cent to EPS for the quarter.

Kimberly-Clark Corporation (KMB)- Top Sell

Date Added	12/13/2021
Market Cap	$45.8 B
Target Price	$120
PE (fwd)	22.0
Short %	2.0%
Current EQ Rating	2- (Weak)

We are moving KMB from our On Deck Sell list to our Top Sell list. The 9/21 quarter was the third consecutive quarter featuring a downgraded outlook. We see signs of continued erosion in earnings quality.

KMB's 9/21 quarter was another disappointment with non-GAAP EPS of $1.62 falling 3 cps below Wall Street targets. The company also lowered the midpoint of its full-year outlook for non-GAAP EPS to $6.15 from prior guidance of $6.78. The 2021 organic revenue growth outlook was reduced to -1% to -2% from the previous 0% to -2% range.

So far this year, guidance was cut by 63 cps after the September quarter, 65 cps after the June quarter, and 45 cps after the March quarter. Keep in mind that after the disappointing quarter in March, the stock price fell to $129 which put it selling at 17 times the 2021 estimate. In the March quarter, the company was calling for higher costs to ease in the second half of the year. Since then it has raised its outlook for key input costs, now calling for an increase of $1.4-$1.5 billion in 2021, up from an outlook of $1.2-$1.3 billion at the end of the second quarter. It also stated it the press release that "it is becoming clear they [higher input costs] are not likely to be resolved quickly." However, the current stock price of $32 is 22 times the 2021 estimate- a 30% increase in valuation from March with a much darker outlook ahead. We continue to see signs of unsustainable benefits in the third quarter which are likely to play out in the quarters ahead. We also remind investors that the 4/20 quarter benefitted from $100 million

- The company has once again expanded the expected size of the 2018 Restructuring Plan. Total charges are now expected to be $2.1-$2.2 billion (up from the previous $2.0-$2.1 forecast.) Interestingly, total expected annual savings are now projected to be $550 million to $560 million compared to the previous $540-$560 million estimate. So, a $100 million increase in plan spending did not raise the top end of the expected annual savings goals at all.

- Remember that KMB cuts costs under the heading of both its 2018 Plan whose costs are added back to non-GAAP results and its FORCE plan which includes ongoing cost savings with no costs added back to non-GAAP figures. After the September quarter, KMB lowered the midpoint of the range of total 2021 cost savings by $10 million to $530 million. This included a $5 million increase in the midpoint of expected 2021 savings from the 2018 Plan (range of $130 million to $140 million) which was more than offset by a $15 million reduction in the midpoint of expected FORCE savings (range of $390 million to $400 million.) The company explained on the call that its forecasted FORCE savings were confounded by production inefficiencies and other disruptions driven by supply chain and employment-related interruptions.

- Stock-based compensation expense moved to a credit of $12 million in the 9/21 quarter from an expense of $47 million in the year-ago quarter. This added almost 14 cps to earnings in the quarter. Management stated in the conference call that this was related to reduced forecasts impacting the outlook for incentive compensation as well as a trueup adjustment. This benefit will disappear in the fourth quarter.

- The company also reduced its forecast for the buyback to $400 million from a previous range of $400 million to $450 million. Capex guidance was also reduced to $1 billion-$1.1 billion from the previous range of $1.1 billion to $1.2 billion. Remember that before Covid, KMB seldom covered the buyback with free cash after the dividend.

- The 12/20 quarter benefitted from a $100 million reduction in promotional accruals which will make for a tougher comp in the 12/21 period.

Mondelez International, Inc. (MDLZ)- Top Sell

Date Added	12/4/2021
Market Cap	$86.9 B
Target Price	$51
PE (fwd)	21.6
Short %	0.8%
Current EQ Rating	2- (Weak)

How the Bulls See It:

MDLZ is viewed as a high-quality packaged food company whose international presence and strong brands give it a superior growth profile compared to many of its peers.

Our Concerns:

MDLZ is constantly in restructuring mode which casts doubt on the quality of the company's non-GAAP earnings. Like most packaged food companies, it has difficulty raising prices more than costs without volume suffering. It also regularly benefits from what we view as unsustainable price increases in Latin America. This happened again in 3Q21.

- MDLZ beat EPS forecasts by only a penny. That alone is a red flag in our view given the constant restructuring. The 3Q tax rate fell 170bp which added 1.4 cents to adjusted EPS. MDLZ also picked up 0.7 cents from lower share compensation. These items alone account for the full beat.

- Normally Latin America sees significant price hikes that offset the FX decline. In 2021, MDLZ has been taking the large price hikes, but FX has been a tailwind too after nearly 20% declines in 2020. As a result, we believe the 15.1% price hike taken for Latin America, will not be sustainable. The size of the price hike was $92 million. If $60 million is not sustainable – MDLZ picked up 3.3 cents in this area.

- Total organic sales growth for 3Q21 was 5.5% with 25.9% growth in Latin America. If Latin America's net price hike had been $0-$30 million, the full company's organic growth would decline from 5.5% to 4.1%-4.6%. This looks like the reason MDLZ boosted revenue growth forecasts to 4.5% for the year. We doubt this continues in 2022.

- Operating margin was down 30bp even with the excessive Latin American pricing – MDLZ noted that promotional spending has returned as we were warning.

- Restructuring costs rose $13 million y/y in 3Q. Net of taxes, it was largely immaterial, but we must ask again why restructuring costs are rising in year 8?

- Biscuit demand has been declining since the 6/20 quarter and accounts for 50% of total sales. Biscuit sales were up only 3.5% y/y adjusting for $32 million in acquired sales. It was up only 1.0% in North America, which is half of all biscuit sales.

Sealed Air Corporation (SEE)- Top Sell

Date Added	12/4/2020
Market Cap	$9.7 B
Target Price	$40
PE (fwd)	18.3
Short %	1.7%
Current EQ Rating	2- (Weak)

How the Bulls See It:

SEE is seen as a defensive stock with a potential for growth propelled by growing e-commerce traffic.

Our Concerns:

- Further weakening in the quality of reported results prompted us to lower our earnings quality rating to 2- (Weak) after 3Q21 results.

- We question SEE's 3Q21 beat of 4-cents which was largely driven by taking a price increase. SEE followed up by cutting forecasts for free cash flow and EBITDA, while not raising revenue or EPS guidance. Even worse than that, SEE didn't raise guidance while forecasting a lower share-count worth 3.5 cents, lower interest expense worth 1.5 cents, lower depreciation worth 2.4 cents, a lower tax-rate worth up to 5.0 cents.

- We wonder if SEE's telegraphed price increase in mid-September led customers to order more heavily before that and effectively pulled 4Q sales into 3Q. We have talked extensively about the price/cost situation at SEE. After 10 quarters of taking more pricing than commodity inflation warranted, this reversed in fiscal 2021. It was a headwind on results of $18 million in 1Q21, a headwind of $36 million in 2Q21, and another $18 million headwind in 3Q21. Yet, forecasts for 4Q require this to become a $40-$50 million tailwind. If sales were pulled forward ahead of the price hike, this may be difficult to reach. Volume comps already look difficult for 4Q:

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Protective Vol y/y	3.8%	15.2%	13.0%	7.4%	4.4%	-8.0%	-2.3%
Food Vol y/y	5.7%	4.2%	-0.4%	0.3%	-1.8%	-1.9%	4.6%

- 3Q21 had several other benefits contributing to its 4 cps EPS beat. A one-time Brazilian benefit added 2.5 cents in EPS. SEE cut stock compensation to add another 2.0 cents. Its tax rate came in below guidance and added up to 1.3 cents. We know SEE has taken huge pricing in Argentina to offset FX losses. It has rolled that into all the Americas unit now rather than a separate South American unit. It also was taking price hikes for FX but 2020 was so bad for FX, the y/y change in FX was positive this year. We estimate this was as much as 1.9 cents in 3Q21- and expect it to reverse going forward. Finally, SEE added back 2.5 cents related to consulting fees for its ongoing restructuring. How many of these items will repeat?

- The protective business has been growing with the company picking up 2-4 cps so far this year from vaccine rollouts. However, the easy comps here are now up and that type of business may not recur at similar levels.

Sysco Corporation (SYY)- Top Sell

Date Added	6/11/2021
Market Cap	$37.8 B
Target Price	$65
PE (fwd)	21.3
Short %	1.7%
Current EQ Rating	3- (Minor Concern)

How the Bulls See It:

SYY is expected to enjoy strong growth from the post-COVID return to dining out. It is the largest restaurant supplier in the country and it added to its industry-leading market share during the pandemic due to its ability to offer value-added services to its customers.

Our Concerns:

SYY topped estimates in the 9/21 quarter by 4 cps and touted higher than expected profitability, but this did not prompt it to raise guidance for the fiscal year ended 6/22. The company sold off over concerns on the Omicron variant. It has recovered some of this ground and could see more near-term gains, but we expect those to be temporary as we believe downside risk remains.

- We have discussed in past reviews how SYY has been adding back the reversals of accounts receivables allowances to non-GAAP results. However, it has only been adding back those reversals related to receivables created prior to the pandemic and is not taking into consideration adjustments made to receivables that were generated after Covid hit. GAAP provision expense adjusted for the add-back of pre-pandemic allowances indicates that non-GAAP results received a 3 cps boost from lower provision expense.

- SYY's non-GAAP results include regular add-backs of restructuring and transformation project costs as well as acquisition-related costs that include the amortization of acquired intangibles. This quarter saw the introduction of an additional disclosure which adds even more adjustments on top of non-GAAP results. These adjustments include costs to hire back employees to replace those let go during the pandemic which management deems "incremental" as well as costs attributed to its very open-ended Recipe for Growth initiative. They also include interest on the debt the company attributed to Covid. Determining what goes into these costs seems very subjective and management anticipates that the 12/21 quarter amounts will at least equal the most recent quarter's total. While the market is still utilizing the previous non-GAAP measure to set targets, investors should be watching for migration of these adjustments into official non-GAAP results or any expansion of the existing restructuring and transformational costs

- While the pandemic cut deeply into SYY's revenue, the company has benefitted in the area of market share as its size and ability to offer higher-end services has allowed it to win incremental business which has impressed the bulls. Longer-term we believe some of these market share gains will prove to be temporary after conditions normalize as many restaurants like to spread their business around to multiple suppliers.

- We also believe supply chain problems and the potential for more Covid restrictions this winter remain potential risks.

TransDigm Group Incorporated (TDG)- Top Sell

Date Added	3/12/2021
Market Cap	$33.4 B
Target Price	$480
PE (fwd)	37.5
Short %	4.7%
Current EQ Rating	2+ (Weak)

How the Bulls See It:

TDG is a leading supplier of aircraft components and has driven growth by acquiring makers of unique replacement parts and increasing prices on customers who have nowhere else to source. The company will drive growth as air travel returns post-pandemic.

Our Concerns:

- TDG has enjoyed an artificial tailwind in the last couple of quarters connected with its use of FIFO accounting for inventory. TDG turns its inventory only 2 times per year. Costs for key raw materials such as aluminum, copper, platinum, steel, tin, and zinc are up more than double where they were selling just a few months ago. The company has been raising prices to offset the rising costs, but it has been expensing the older, lower-cost inventories against these elevated sales over the last couple of quarters. Gross margin has skyrocketed as a result, but this will begin to play out over the next one to two quarters as the lower-cost inventory is replaced at much higher costs. The slower inventory turn means that the negative impact could be felt for multiple quarters.

- Raw materials and work-in-process inventories should be increasing significantly as a result of higher raw materials prices, but both are declining which indicates the company is selling out faster than it is replacing inventory. This will be a huge drain on cash flow as it begins to spend to replace inventory at much higher prices.

- The inventory thesis is backed up by the fact that the company just guided towards EBITDA margins of 47% for the fiscal year ended 9/22 which does not compare favorably to its pre-Covid levels of 49%.

- As we expected, the company began cutting its inventory reserve which boosted EPS by 4 cents in the 9/21 quarter. We may see more cuts to the reserve in the next few quarters which could artificially offset some of the impact of rising costs.

- We remain concerned about the high debt load the company has amassed over years of acquisitions. It continues to refinance to longer maturities to attempt to avoid rising interest rates. However, the elevated interest expense deduction in effect during Covid has now disappeared and the tax rate is rising again.

- The debt problem is further magnified by the tax shield disappearing under section 163(j). Previously, the amount of interest TDG could shield against taxes was 30% of EBITDA and now that is 30% of EBIT. Under the CARES act, during the pandemic companies were given a two-year reprieve where they could shield 50%. This already drove the 3/21 quarter effective tax rate to 19.6% from 4.2% y/y largely as a result of section 163(j). We estimate this will be about 20-30-cents in EPS per quarter this year. This effectively reduces ROI and the amount of debt TDG can carry.

- Recent growth is coming more from defense contracts and less from travel returning.

- We see a risk of impairment from contracts related to older aircraft where the original assumptions call for these planes to be in service for 30 years, yet accelerated airline fleet upgrades may significantly reduce these useful lives.

- We believe the quality of earnings is eroded by the company's practice of adding back the amortization of contract loss reserves.

“On Deck” Sells

These are companies under coverage with material problems but are not currently on the Top Sell list due to valuation or timing factors.

Ball Corporation (BLL)- On Deck Sell

BLL reported non-GAAP EPS of $0.94 in the 9/21 quarter which fell 4 cps short of the consensus target. However, the adjusted effective tax rate was 11.6%. The company attributed the lower tax rate to higher R&D tax credits. Going into the quarter BLL was forecasting a full-year tax rate of 17% which is closer to what most analysts were likely expecting. We estimate this added about 7 cps of unexpected benefit to the quarter so we view the miss as worse than it appears at first glance.

We continue to see working capital issues as well as the company continues to stretch working capital to finance its capital expansion activity.

- Cash from operations for the 9 months ended 9/21 rose by $531 million. This was penalized by a $400 million increase in the drain from growth in receivables but was more than offset by an unusual $780 million jump in accounts payable. Some of this is likely due to replenishing inventory at higher cost but payables/inventory has risen YOY for the last three quarters which we believe indicates the company may be taking longer to pay its suppliers.

- Outstanding factored receivables fell to $1.27 billion in the 9/21 quarter from $1.37 billion in the year-ago quarter and $1.47 billion in the 6/21 quarter. The limit on the factoring program also declined slightly from the previous quarter. This decline in factoring activity is notable as an expansion in receivables factoring has been a key source of financing the company’s aggressive capacity expansion.

- Without the accelerated receipt of cash from expanding payables and factored receivables, BLL would not have come close to covering the current buyback and dividend in the trailing 12 months ended 9/21. If we count the increase in payables and factoring as debt, the leverage ratio jumps to 4.1. We understand that if the company can get all the new production up and running and sell the cans at expected prices then cash from operations will expand, capex will come down, startup costs will subside, and there will be plenty of cash to reduce debt and return to shareholders. However, the short-run seems to depend very much on unorthodox short-term financing which does not show up in some investors' debt metrics. It does not seem to us that this risk factor has enjoyed much public discussion.

Cintas Corp (CTAS)- On Deck Sell

We added CTAS to our On Deck Sell list on 10/7/21. The company has benefitted from good employment numbers which could continue for a while. However, we see the potential for problems developing with the company's large inventory reserve established last quarter.

CTAS reported EPS of $3.11 in the 9/21 quarter which was 35 cps ahead of the consensus estimate. However, the company's outlook for FY '22 given at the end of last quarter called for the tax rate to increase to "19.5%-20.5%" from FY '21's 13.7%. The company has highlighted the negative impact this would have on FY '22 results. However, the effective tax rate came in at 11.0% in the 8/21 quarter versus the year-ago period's 7.8%. While this was a headwind to EPS growth in the quarter, we suspect it was likely well below the tax rate most analysts had modeled. Since every percentage point change in the tax rate would have impacted EPS by about 4 cents, we could easily see the lower tax rate accounting for 20-30 cps in the upside versus consensus. We also note that the company spent $400 million on share buybacks in the 5/21 quarter followed by $660 million in the 8/21 quarter with the resulting decline in the share base adding about 6 cps to EPS growth. Offsetting some of these benefits was a 5.5 cps increase in stock compensation expense. Still, the earnings beat is less impressive than it appears at first glance.

- We noted in our last update on CTAS that the company dramatically increased its reserve for obsolete and slow-moving inventory which was largely related to its inventory of PPE products. We were concerned that the company would be able to sell this inventory in the next couple of quarters and realize unusually high profits due to the reduced cost basis. However, the reserve stayed essentially flat in the 8/21 quarter indicating that the company was unable to move meaningful amounts of this inventory. The reserve as a percentage of gross inventory has remained at roughly double the pre-Covid norm for the last two quarters.

- First Aid and Safety Services revenue fell by 2.6% and segment gross margin improved to 44.8% from 40.2% in last year's August quarter. However, the improvement in gross margin was due to a mix shift away from lower margin PPE products and segment gross margin remained well below the 2019 level of 49%. This coupled with the still elevated inventory reserve does not make us think the quarter benefitted meaningfully from selling reduced cost basis PPE inventory. However, the reserve balance and what we are hearing about demand and pricing from other players in the PPE area such as PDCO makes us believe the company may very well have to incur additional reserves or write-downs in upcoming quarters.

- Like most other companies, CTAS is facing both higher materials cost and labor cost headwinds. Management also reminded investors that a large portion of its costs are capitalized into rental inventories and recognized over time. However, the company is currently raising prices to cover the costs so it will get the full beneficial impact of that immediately. While this effect will boost margins in the next quarter or two, it is setting the company up for possible disappointments after that when price increases stop and the higher cost inventory is still being amortized.

- We also note that the company mentioned in its discussion of results that an asset sale helped offset the impact of higher costs on SG&A expense. However, this was not quantified in the 10-Q or the conference call so we do not know the impact on earnings.

Eaton Corp. (ETN)- On Deck Sell

ETN has been beating forecasts in the last few quarters. It has been a huge beneficiary of conditions normalizing after Covid and a high backlog should help propel strong sales growth for the rest of 2021. However, ETN has received some temporary non-operational benefits that will disappear and lead to more difficult comps next year. This prompted us to move ETN to the On Deck Sell list.

- ETN began adding back the amortization of intangibles to non-GAAP results. While this was a known event, it nonetheless added 18 cps and 25 cps to the 3/21 and 6/21 quarterly results and now 25 cps to the 9/21 quarter. This is increasing the spread between GAAP and Non-GAAP results which should exceed $1.00 now and boosting earnings at a time the stock is already trading for high multiples of 27x adjusted EPS. It is also worth noting that guidance for the year was for adding back amortization to add 70 cps to adjusted EPS. It may come in at 93 cps.

- Freezing US pension plans at the start of the year and paying out some lump-sum distribution has reduced service cost and some amortization y/y in the last three quarters. Pension income in 3Q21 vs. the expense in 3Q20 was a $23 million positive swing adding almost 5 cps to results. We don’t regard this as a true improvement in operating results.

- We estimate that ETN picked up 85bp of operating margin in 2Q21 simply from Covid pent-up demand being met and leveraging costs like depreciation and R&D. That's nearly 8-cents in EPS last quarter. Going forward, R&D is increasing again and the sales comps are not nearly as easy as 2Q. As expected in 3Q21, R&D came in at 309bp vs. 292bp in 3Q21 as this became a headwind for earnings after the margin gains of 2Q.

- Divesting the lighting business and the hydraulics unit helped margins too. Both of these had EBITDA margins of about 11% and subtracting them gave the remaining ETN business an increase in margin of 190bp. Those units were classified as discontinued for most of 2020. We think Covid's lower sales masked some of this benefit that is being seen in 2021. This is not an item that should improve further.

- Recent acquisitions came with much higher margins. So far Tripp Lite with an EBITDA margin of 34% has only been in place since mid-March and Cobham's 29% margin since June 1. Simply adding these to the mix should boost margins by 50bp. There are 3 more quarters of apples-to-oranges comps to come. However, we again do not see this as a source of never-ending margin gains. Aerospace sales grew $205 million but $178 in the 3Q was from the Cobham acquisition. With its margin above ETN's, margins rose to 22.0% from 18.5% in aerospace. Cobham likely made the difference there. Even with Tripp Lite, the margins in Electrical Americas were down 50bp. We believe FIFO accounting likely helped ETN boost margins at other units.

- Payables are normally about 50 days, they stretched to 64 days after 2Q and are now 71 days after 3Q21.

Kyndryl Holdings, Inc. (KD)- On Deck Sell

- KD was spun-off from IBM on November 3. This unit was the focus for much of the huge restructuring charge IBM took in 4Q20. They have filed a 10-Q through September 30, so nearly everything so far includes proforma numbers. We expect the 4Q21 results to have several more proforma adjustments as the spin-off occurred during the period and the large charge from 4Q20.

- We can see that IBM pushed $955 million in pension liabilities to KD that appear largely unfunded. We also saw that IBM reported a proforma pretax income for KD's 3Q of $60 million and YTD of $61 million. However, lower pension expense was $7 million of that in 3Q, and $15 million YTD.

- During the first nine months, bad debt reserves fell by $33 million which also helped the YTD proforma income of $61 million. Also, advertising fell by $6 million. The 3Q saw these items add $4 and $1 million. R&D fell by $14 million YTD and $3 million in 3Q. That alone has wiped out KD's YTD income. At the moment, it is not clear if KD removed a $20 million gain from property sales from the $60 million in pretax income it reported. Every item it adjusted for to get to the $60 million was either spin-off or IBM-related.

- Looking at the huge charge from 4Q20 that suddenly allowed IBM to report much lower workforce rebalancing changes – KD reported that this ongoing cost declined by $316 million YTD. Again, here is 5x the reported income YTD and we would expect this cost to increase going forward as it was a constant item at IBM. It was actually a $1 million benefit in 3Q21. Also, IBM didn't add it back to its earnings for decades until the 4Q20 charge. What should be alarming too is KD reported that proforma gross profit before all "one-time" items rose only 20bp in 3Q and YTD based on the huge workforce restructuring charge in 4Q20. Of more concern, in 4Q20 and 1Q21, IBM touted how it had reworked numerous uneconomic contracts with customers at the KD unit, which should have helped gross profit margin too in 2021. Revenues are down 5.7% in 3Q accelerating the decline from 0.5% in the first two quarters.

Mohawk Industries, Inc. (MHK)- On Deck Sell

MHK reported non-GAAP EPS of $3.95 for the 9/21 quarter which was 15 cps ahead of consensus. However, revenue missed targets by almost $90 million, and the company guided to 12/21 quarterly EPS of $2.80-$2.90, well below the $3.22 consensus. This led to an eventual 10%+ stock price decline. The stock has regained some of this ground and we continue to see signs of weak earnings quality.

- Warranty accruals continued to decline despite increasing sales. MHK increased the warranty reserve during the pandemic and is now bringing it down which appears to be causing an artificial boost to earnings. Warranty accruals on a days-of-sales basis are at 1.5 which is below both year-ago levels of 1.9-2.5 and even pre-pandemic levels of 1.7-1.8. The reserve balance itself fell to $43.3 million from $53.5 million a year ago despite the 9% increase in revenue. While we don't have provision and usage data to calculate an exact earnings impact, we estimate it would have taken about 14 cps off earnings growth to move the warranty reserve to the year-ago level relative to sales.

- Like many companies, MHK built allowances for bad debts during the pandemic and it is now seeing those decline which is providing an artificial tailwind to earnings growth. The allowance for bad debts as a percentage of gross receivables fell to 4.3% from 4.8% in the year-ago quarter. The 4.3% is more in-line with pre-pandemic experience. While we don't have the provision expense and usage data to be able to calculate the exact impact on earnings, we estimate that if the reserve percentage had remained the same as the year-ago level it would have shaved about 11 cps off of earnings growth. Assuming the reserve percentage levels out in the low 4% range, the earnings tailwind still has a couple of quarters left to run after which it will play out as comps normalize.

- MHK capitalizes costs to obtain contracts which include the cost to install in-store displays and it amortizes these costs over the expected time of benefit. It has been capitalizing less since the pandemic began which is likely due to the pandemic limiting the placement of new in-store displays. However, amortization as a percentage of average capitalized balances has been declining and fell from 26.2% last year to 24.1% in the most recent quarter. If the percentage had remained constant, we estimate it would have taken about 1.5 cps off of earnings in the 9/21 quarter. This also highlights that the company will likely see these contract costs rise as conditions normalize post-Covid.

Patterson Companies Incorporated (PDCO)- On Deck Sell

We are moving PDCO to the On Deck Sell list from Top Sell due to the price decline.

- PDCO beat forecasts in 1Q22 by 6-cents and in 2Q22 by 8-cents. After 1Q, PDCO did not raise guidance and after 2Q it raised by only 5-cents. We think both beats were full of one-time items and are not high-quality. A big part of this was having lower losses y/y on the sale of equipment finance contracts. That added 1.6-cents in 1Q and 3.7-cents in 2Q. 1Q had an extra week worth 2.8-cents, lower stock compensation adding 1.4-cents, and a lower tax rate adding 2.3-cents. 2Q benefited also from an insurance reimbursement of 6.1 cents and 1.1 cents from lower stock compensation.

- We know that 2Q22 EPS was down 5-cents y/y, which management attributed to some of the Covid furloughs and lower travel expenses ending in 2Q21 but still not being fully restored. However, the 10-Q notes that overhead costs rose by $16.9 million from higher wages and travel – but that was offset by the $8.0 million insurance settlement. Thus, does next quarter see a headwind greater than $24 million as wages and travel costs rise even more but there's no insurance check coming?

- Free cash flow in the first half of fiscal 2022 saw a positive swing of $60 million from -$28 million to $31 million. That was entirely driven by collecting $177 more in deferred purchase price receivables on securitized receivable and sold financial contracts. PDCO has drawn this balance down and there is simply a smaller figure of deferrals to collect in the near future and this may hurt free cash flow.

- Gross margin fell 60bp in 2Q22 by selling a higher percentage of lower-margin animal products over dental. However, dental margins were flat y/y and animal margins improved. Also, this runs counter to 1Q guidance that PDCO would see increasing margins through 2022, but it posted lower margins in 2Q and guided to more pressure for 3Q. This also comes after all the fireworks with PPE (Personal Protective Equipment) sales in 4Q20 and 1Q21 when it wrote off $60 million of inventory. Comps are set to get tough for the animal business too as PDCO has double-digit growth rates to match against for several quarters now.

- PDCO's sales guidance is calling for 3Q to be mediocre and 4Q to show the real growth. It is blaming supply chain disruptions, especially for equipment. We have three problems with this. First, XRAY, one of its largest suppliers, is claiming it is meeting orders. Second, supply chain issues have been in the news for over a year now – why didn't they impact PDCO's huge sales gains in 3Q21 which were higher than what PDCO hoped for. Or, in 4Q21 when equipment sales were up 65% or 1Q22 with sales up 28% and 15% above the pre-Covid figure? Third, PDCO continually touts how many private-label products it is rolling out (this is not an issue for equipment but products in general). Typically, private-label means lower prices to the customer and that hurts revenues. Private-label also makes it tougher for PDCO to hit rebate levels with suppliers, which also hurts results

Stanley Black and Decker, Inc. (SWK)- On Deck Sell

We are adding SWK to our On Deck Sell list. We lowered our earnings quality rating on the company after the 9/21 quarter results.

SWK initially reported non-GAAP EPS for the 9/21 quarter of $2.77. However, a few days after reporting the quarter, the company announced it received a comment letter from the SEC instructing it to utilize the if-converted method to account for its forward stock purchase contracts rather than the treasury stock method. This increased the number of shares utilized in its EPS calculation which would have resulted in 9/21 quarter non-GAAP EPS of $2.71. It also shaved 20 cps off the company's previous guidance for the full year ended 12/21.

Profitability was hit hard in the quarter as adjusted operating margin fell from 17.7% a year ago to 12.2% in the current quarter as raw materials and shipping costs rose. SWK lowered the mid-point of its guidance for the full year to $10.80 from the previous $11.50, down 70 cps. The company noted the following factors behind the lower outlook:

Higher commodity, transit, labor	-1.25 cps
FX impact	-0.15 cps
Change to if converted method	-0.20 cps
Tax rate and other below line items	+0.60 cps
Pricing and cost control	+0.30 cps
	-0.70 cps

Despite the cost pressures, the revised $2.71 per share for the 9/21 quarter was 24 cps ahead of the consensus estimates. However, we identified several times we consider to be non-operational without which the company would have reported disappointing results.

- The adjusted tax rate fell to 2% which was down dramatically both from the year-ago level of 17.8% and the 15% full-year rate forecasted by the company after the second quarter's results. If the tax rate had been 15%, we estimate it would have taken over 35 cps off of earnings in the quarter. The company attributed this to benefits from its supply chain initiatives.

- "Other, net" expense fell by 19 cps after adjustment for cost reduction programs and deal transaction costs. The company attributed this to the appreciation of Stanley Ventures' investments. We view this as a largely unexpected and low-quality source of growth.

- The provision expense for doubtful accounts fell to 0.08% of sales in the 9/21 quarter from 0.20% in the year-ago quarter. This added about 2.4 cps to earnings in the period. The allowance for doubtful accounts as a percentage of gross receivables was down to 6.5% which is more in line with the low 6% range seen before the pandemic and well below the 8.5% from the 1/21 quarter. The tailwind of lower provision expense looks like it has largely played out.

- Lower pension expense added about 1.5 cps to the quarter. This was largely driven by a decline in the interest cost component due to a lower assumed discount rate. This benefit will likely disappear next year when the assumed discount rate will presumably rise.

Teva Pharmaceuticals (TEVA)- On Deck Sell

We are adding TEVA to the Focus List as an On Deck Sell below $10. Potential opioid litigation limits may rally the stock for a better entry point. There appear to be several other headwinds that could create problems for results in the next several quarters.

- Sales growth is already negative for 3Q and YTD. That is despite contra-accounts to sales such as rebates, chargebacks, returns, and government discounts remaining below normal levels too. These lower contra-account entries are also helping gross margin on net sales improve about 100bp while margin on gross sales has remained flat. Thus, TEVA could see sales growth declines accelerate and margins fall.

- Contra-accounts are running about 45% of gross sales now, but have a history of being >49% of the total. Thus, TEVA could see sales growth slow from here by simply having these items return to normal. Adjusted EPS guidance is for $2.50-$2.70, the lower contra-accounts are adding about 60-cents to that figure.

- Debt is being paid down, but TEVA's guidance of 3x EBITDA by the end of 2023 looks too optimistic. Free cash flow is under $2 billion per year, and TEVA would need to retire $7 billion in debt in the next two years. Also, EBITDA is inflated by the lower-than-normal contra-accounts too, which could lower EBITDA going forward and boost the net debt/EBITDA ratio from its current 4.5x.

- Other issues with debt include TEVA is already pulling in cash from securitizing receivables and its net debt includes $2 billion in cash on hand. However, it also has a $2 billion accrual for legal costs. Excluding the cash from the debt/EBITDA formula makes current debt 4.9x EBITDA. Excluding cash and the current reduced level of contra-sales items, Debt would be $23.7 billion and EBITDA about $4 billion or 5.9x.

- Litigation accruals have been running far below normal too in the last two years. It was only $60 million in 2020 and $113 million through 3Qs of 2021. That compares to several years of greater than $500 million and others over $1 billion. TEVA adds this back to adjusted EPS; however, it can be a sizeable cash outlay too which would hurt debt repayment goals. This is a wildcard item in regard to timing, but TEVA's operating model focuses on challenging patents and risking lawsuits in numerous districts in addition to tort-style lawsuits like opioids. We consider this an ongoing cost too. In any given year, litigation costs are 10-40 cents of the $2.50 in adjusted results.

TreeHouse Foods, Inc. (THS)- On Deck Sell

We are removing THS from the Focus List as they have announced they are attempting to sell the company.

Top Buys

Air Lease Corp. (AL)- Buy

Date Added	12/4/2021
Market Cap	$4.4 B
Target Price	$65
PE (fwd)	12.8
Short %	3.5%
Current EQ Rating	4+ (Acceptable)

- AL is a longer-term play in our view as EPS rebuilds to over $5. Three issues have worked against them with Covid: customers needing rent relief, delays/shortages in obtaining new aircraft, and its trading operation lacking volume in used aircraft to sell.

- Rent relief is improving rapidly at this point. If a customer cannot pay, AL stops accruing rent and records it only when cash is received. Early in Covid, that reversed revenue already booked and delayed it. It becomes almost like backlog where early on revenue is lower and later AL starts to receive higher rental payments from current and deferred balances. In 3Q, AL beat forecasts on EPS and revenue largely due to receiving cash rent from Vietnam Airlines. Net rent deferrals are $118 million, up only from $115 million in early August and 54% of deferred rent has been repaid. The collection rate on rent was 94% in 3Q, up from 87% in 2Q and 84% in 1Q. AL also noted that it is seeing a decline in requests for deferrals and restructuring of leases was down to only a $27 million impact in 3Q down from $42 million in 2Q and $49 million in 1Q.

- Delays in obtaining new aircraft continue. It took delivery of $800 million in new aircraft in 3Q vs. the $1 billion expected. It believes that only 15 of the scheduled 25 new planes will arrive in 4Q. This problem should extend well into 2022 but there are signs it is not as severe as in late 2020 at this point.

- AL's operating model is to sell its planes within 6-10 years of obtaining them even if they are under lease. The goal is to sell planes when they are still young (< one/third of their useful lives) to maximize resell value and recycle the capital into new planes. This trading business normally sells 20-30 planes per year and AL books gains on the sales that are as much as 10% of EPS. With the delays of new planes arriving, AL has opted to keep planes in its portfolio longer and does not expect sales in 4Q. We do believe trading volume will recover as new deliveries recover.

- AL’s newer planes remain highly desirable and the usage rate by its airline customers for AL planes is 99.7%.

- The accounting is conservative and the company has significant liquidity. At some point, AL will either need to find ways to expand the number of planes it has with more sale-leasebacks with customers, or it can retire debt and shares and grow EPS with the current fleet. We think either way – there should be more potential for improvement in the results.

- There is a nice tailwind developing for AL to grow. Airline customers have higher borrowing costs than AL and can utilize AL’s balance sheet more heavily to finance their fleets. AL is seeing leasing take market share from airline ownership of new planes. Before Covid, 40%-45% of new aircraft deliveries were financed with leasing with companies like AL. Now AL is reporting that 60% of deliveries are being financed with leasing. Also, AL is working with existing clients to do sale-leasebacks of existing planes in their fleets that meet AL’s criteria of model type and age. When this is all complete, AL could have earnings power that well exceeds $5.

AT&T Inc. (T)- Top Buy

Date Added	3/12/2021
Market Cap	$195.1 B
Target Price	$40
PE (fwd)	8.5
Short %	1.5%
Current EQ Rating	4+ (Acceptable)

Longer-term, while investors are giving up 88 cps in annual dividends, they are getting:

- 71% of NewCo which we value as high as $10 per share. Forward EBITDA is forecast at $14 billion when the spin-off occurs in mid-2022 with $60b in debt. Warner assets have sold for over 12x, at 10x – 71% of the spin-off is worth $7.90 per share to AT&T shareholders.

- Faster growth at NewCo (vs AT&T) should drive further capital appreciation. That company will also look to reduce debt. Without changing the EBITDA multiple or earnings – every $1 billion in debt reduction should boost the stock value owned by AT&T shareholders by 10-cents. The target is to reduce NewCo's debt by $15-$18 billion within 24-months.

- Debt at T should decline from $168 billion to under $100 billion at the time of the spin-off with $43 billion being sent to NewCo, asset sales that already occurred and free cash flow after the divided being devoted to debt reduction. That should save AT&T $3 billion in interest expense. Lower interest expense and higher free cash flow after the dividend should allow continued debt reduction at AT&T too. Debt to EBITDA is currently 3.15x and should be 2.6x after the spin-off falling below 2.5x by the end of 2022.

- The benefit of maintaining HBO Max bundling deal.

- More investment in T's core business to drive future growth – Broadband is expected to double in size within 5-years.

We continue to value the sum of the parts at least $40. The simplest way to look at it is AT&T's wireless unit is growing even without roaming fees from international travel. VZ normally trades for 8x EBITDA, AT&T's wireless at 8x less the entire company's remaining $100 billion in debt would be worth more than $20 by itself. The spin-off is worth between $7-$10 and the whole company is valued under $23 in the market today. Investors get the growing broadband (CAGR of 14%) and the cash flows of business phones and several other parts for free with no debt associated with them as we already deducted all the debt from wireless. In addition to growth, there are plans to create shareholder gains via deleveraging both AT&T and NewCo.

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

Date Added	7/14/2021
Market Cap	$31.4 B
Target Price	$140
PE (fwd)	4.9
Short %	1.6%
Current EQ Rating	5+ (Strong)

- Demand is high and plastics are in short supply leading to higher prices and rising EBITDA. Industry maintenance and building delays will keep supplies down and prices high.

- Cash flow is strong and the company is retiring debt. Net debt is $12.7 billion and the company has plans to push it below $12 billion. The debt rating was upgraded by S&P and leverage is 2.05x trailing EBITDA. We expect it will be under the 1.5-2.0x target by the end of the year.

- The Advanced Polymer Solutions segment is posting flat results due to the semiconductor shortage hurting car and appliance production. However, this problem should start reversing in the fourth quarter and result in strong demand in 2022.

- With new production already online – LYB's base EBITDA is $8 billion which can move up on stronger pricing and additional capacity coming within 2 years. We see LYB as being very cheap at these levels. If the stock rose 47% it would still be trading for only 7x base EBITDA that is already producing and the base may rise to $9 billion with other new capacity coming online.

- R&D and SG&A are up- we see earnings quality as very strong.

- LYB reiterated that it may sell its refinery in the near future. Historically, this has been produced the most volatile results for the company. (See the -$81 million in EBITDA for 2Q21 followed by $41 million for 3Q21).

- LYB has a market cap of $30 billion and will have debt less than 1.5x EBITDA. Free Cash Flow should be around $5 billion, and the dividend at $1.5 billion would allow them to retire 10% of the stock per year. LYB has a history of hefty share repurchases exceeding $3 billion annually, the share count of 334 million is down from 487 million in 2014.

Mowi ASA (MHGVY)- Top Buy

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

- MOWI has resumed dividend payments and extraordinary dividends at this point. We believe this can continue to increase going forward as the company intends to pay out 50% of income. MOWI has a record of paying 2.6 NOK per quarter vs. the latest 1.4 NOK in 3Q21 so there is still room for the yield to improve.

- The NOK (Norwegian Krone) to USD exchange ratio fell about 10% during the Thanksgiving Covid fears. It's only gained about half of that back, so there is still some free upside in the ADRs of that normalizing.

- Significant growth should start coming from more salmon volume. MOWI is investing heavily between 2021-26 on freshwater tanks to hold salmon smolts until they are larger. This means less growing time in seawater, which will allow the company to produce more volume with the same seawater pens. It should also mean fewer health and parasite issues. These higher volumes should begin appearing in 2024.

- Demand is exceeding supply and frozen inventories in the industry have been worked down. Pricing has recovered significantly. MOWI has benefited by selling more salmon at growing spot prices. It intends to increase the percentage of sales under contract for 2022 at higher levels. Chile has been the swing producer and overproduced in 2020 and now is producing less volume. That should help will into 2022. Demand is still not fully restored in Asia with fewer flights and as that corrects demand is expected to exceed supply into 2023.

- A focus to increase demand in the US by 2-3 fold over 7-10 years is now underway after Covid delays. This is being done with investments made in processing plants and distribution centers already in place. MOWI is rolling out branded product to restaurants and retailers with an emphasis on reaching consumers directly. These consumer products sell at a premium to whole salmon and should also help drive revenues higher over time.

- We anticipate inflation will boost working capital and capital spending levels are a bit higher than normal – both of which should offset some of the pricing benefits to cash flow.

However, debt remains low and the earnings should continue improving on the favorable supply/demand situation.

National Instruments Corporation (NATI)- Top Buy

Date Added	3/12/2021
Market Cap	$5.7 B
Target Price	$52
PE (fwd)	26.4
Short %	2.3%
Current EQ Rating	5+ (Strong)

- The story at NATI remains backlog building. This is costing the company sales in 2021 but should turn into extra sales in 2022. Think of it as running in 2021 on quarters of only 11-12 weeks instead of 13 and next year could see quarters equivalent to 14 to 15 weeks of revenues instead of 13.

- Normal backlog is one week, it reached four weeks after 2Q21, five weeks after 3Q21, and is expected to top six weeks in 4Q21 results. It has not had issues of double ordering or cancellations of backlog. A week of backlog is about $28 million in sales.

- In 3Q21, NATI's $0.42 of EPS beat estimates by 3-cents. A lower tax rate provided the 3-cents. However, NATI also faced a headwind from higher variable compensation that cost it EPS. Plus, adding a week to backlog rather than sales cost it $20 million in gross profit which is 12-cents in EPS. We believe there is considerable earnings power coming when the backlog declines in 2022.

- NATI also budgets for its R&D and G&A costs as if it was getting the full amount of sales rather than have one to two weeks go into building backlog. Thus, these costs are not leveraging as much as they should. We would expect to see margins increase next year too on normalizing sales. NATI also guided to variable compensation leveling out next year and not being a headwind. In 3Q, adjusted R&D and G&A were $209 million or 57% of reported sales of $368 million. An extra week of sales would mean the top line is $396 million and overhead costs only 53% of sales – margin would improve 400bp. We think NATI can reach its 2023 goal of a 20% gross margin in 2022 with this type of situation.

- Another catalyst to converting the backlog into sales is NATI's inventory is starting to build again to pre-Covid levels, which should speed the fulfillment of orders. Historically, NATI carried about 220-250 days of inventory by design. It wanted to avoid out-of-stock situations and be able to rapidly fill larger orders. Inventory sank to 167 days in 4Q20, but is now back at 218 days:

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20
Inventory	$237	$211	$197	$194	$210	$210
Inv. DSIs	218.0	201.2	196.3	167.6	215.4	228.6

Texas Instruments Incorporated (TXN)- Top Buy

Date Added	3/12/2021
Market Cap	$181.0 B
Target Price	$216
PE (fwd)	24.3
Short %	1.8%
Current EQ Rating	5+ (Strong)

- TXN is still having a tough time rebuilding inventories. DSI's were only 113 days after 2Q21 down from 125 in 4Q and a normal level above 140 days. It's worth noting that finished goods are only half of last year at 40 days vs. 77. That has helped cash flow of late but could pressure sales growth. Because TXN holds more inventory than many competitors – it may be gaining more future business as a result of all the Covid disruptions.

- We remain impressed with TXN's earnings quality overall. It didn't cut R&D and overhead during Covid so now the higher sales leverage into higher margins and earnings.

- TXN continues to boost its dividend that remains well within its ability to fund it.

UnitedHealth Group Incorporated (UNH)- Top Buy

Date	3/12/2021
Market Cap	$450.4 B
Target Price	$500
PE (fwd)	25.4
Short %	0.6%
Current EQ Rating	5+ (Strong)

- UNH is now past the difficult comps from Covid when it was collecting premiums, but people were not visiting the doctors' offices which inflated the medical ratio and operating income. It is still expecting $1.80 negative impacts from COVID in 2021 but beat forecasts by 10-cents in 3Q and raised top-end guidance by 10-cents to $18.90.

- The company's tax rate is lower with the repeal of the health insurance tax, January 1. That has enabled the tax rate to decline 260bp YTD and 270bp in 3Q. This was a known event and it helped EPS growth by 15-cents or 4.3%. This y/y benefit will lap after 4Q.

- During Covid, UNH was posting higher revenues from premiums and also rebates that it earns. Yet, it could not bill for the rebates at the time because patient visits were low. That is normalizing too and allowing UNH to see more cash flow rather than building accruals.

- The company routinely covers acquisitions, dividends, and share repurchases from free cash flow. Our biggest concern is the repurchases are producing almost no impact on EPS growth and we wonder if UNH could find better avenues for growth with that cash. In the 3Q21, share repurchases added only 3-cents to EPS of $4.52, which was 0.7% incremental y/y EPS growth. However, UNH spent $5.66 billion on shares in the last 12 months for that meager amount of growth. If it could have used some of that cash to boost revenue growth by only an incremental 1%, it would add 5-cents to quarterly EPS.

United Rentals, Inc. (URI)

Date Added	12/13/2021
Market Cap	$25.2B
Target Price	$380
PE (fwd)	16.0
Short %	3.1%
Current EQ Rating	4+ (Acceptable)

- Demand remains high in several areas of construction and maintenance/repair. With commodity inflation and supply chain issues, this should also benefit URI more since customers would need to pay more to buy equipment even if they can get it. URI is one of the largest players in the industry and purchases large volumes of new equipment annually, which means it should have better relationships with supplies to ensure it still gets as many of its new orders as possible.

- URI missed forecasts in 3Q by $0.24 in reporting adjusted EPS of $6.58. However, it boosted guidance following the miss for EBITDA, Cash from Operations, and the amount of capital spending. The miss was due to positive items:

    - URI paid more bonuses to employees because of an increase in business. It did not fully quantify the size of the higher accrual, but stock compensation rose $15 million y/y and cost adjusted EPS 15.4 cents.

    - URI had a smaller insurance payment that came in for damaged equipment which fell from $21 million in 3Q20 to $5 million in 3Q21 – this was 16.5 cents.

    - With shortages and high demand – URI did not sell as much used equipment since it can still rent it at high fees and it is more difficult to replace it. Sales in 1Q were $59 million higher y/y and in 2Q $18 million higher y/y. In 3Q, they declined $16 million. The prices they are getting on used equipment are rising and the gross profit was actually up in 3Q by $8 million on the lower sales, vs. up $13 million and $20 million in 2Q and 1Q. We would estimate URI likely gave up about $10 million in income in this area or 10-cents in EPS.

- We applaud the conservative accounting at URI. Its largest adjustments between GAAP and adjusted earnings are adding back acquired intangible amortization and restructuring/integration charges. However, keep in mind:

    - URI acquires companies that are growing and at lower multiples than itself.

    - It amortizes intangibles quickly – over 5-10 years.

  - It does not forecast outrageous synergies – normally about 20% which is often doable simply by consolidating real estate.
  - The restructurings actually end.
  - URI depreciates equipment to salvage value of 0%-10%. It appears to be recovering more than that with gross margin on used equipment sales rising to 46% in 3Q.
- Heavy and recurring capital spending makes EBITDA an unrealistic metric to examine for assessing how much debt URI can support. Even URI management makes the same claim, which is why it has a debt target of only 2-3x EBITDA and is 2.4x now. That is also why URI focuses more on free cash flow in assessing its debt level and gives forecasts for capital spending.

Lamb Weston (LW)- On Deck Buy

We added LW to our On Deck Buy list on 10/12/2021 at a price of $55. Valuing LW is a challenge as it does not have any direct public comparisons. Looking at the recent past as a guide, normalized EBITDA is around $900 million implying an EV/EBITDA of around 10x. Comparing that to Kellogg's EV/pre-pandemic EBITDA of over 13 makes LW seem relatively cheap. However, it could take some time for this value to be realized as there as some potential stumbling blocks remain.

The company is seeing a return to away-from-home dining which helped drive an 11% increase in volume against relatively easy comps last year. Pricing rose by 2%. Management admitted the Delta variant weakened away-from-home demand in August. However, absent significant shutdown orders this winter, the top line should not be a problem especially as difficult retail comps normalize going forward. It is worth noting though, that management was somewhat worried about the possibility of delayed shipping and container availability having the potential to stunt volume growth.

The stock fell about 10% since the 8/21 quarterly earnings release. The bulk of the disappointment was centered around the company's higher-than-expected costs with management placing most of the blame on what it deemed the worst potato crop in its history along with a doubling in the price of edible oils. Also cited were labor challenges and production disruptions driving up unit costs. Prior to the August quarter, the company was anticipating gross margins would climb back to pre-pandemic levels of 25-26% by the end of the fiscal year. Now it is calling for pressure to continue throughout the remainder and margins to be 5-8 percentage points below that level for the fiscal year. We have several observations regarding LW:

- We currently rate the company's earnings quality as 5+ (Strong). Non-GAAP adjustments are practically non-existent. The major adjustment to earnings to be made is the unrealized gains/losses from hedging-related mark-to-market activity. This adjustment actually turned against the company in the 8/21 quarter as a decline in the size of unrealized gains relative to last year shaved 3 cps off of the reported earnings growth.

- The company essentially makes one thing- french fries. Over 10% of sales are to McDonald's. The french fry market is controlled by LW and two other companies and the industry is not impaired by cutthroat pricing. This makes the demand for the company's product very predictable and stable over time. The downside is the company is exposed to a weak potato crop both in terms of pricing and in terms of quality as a poor-quality crop results in higher production costs. We suspect that concerns over climate change are amplifying the recent focus on the bad potato crop. Management anticipates meaningful insight over the next two months into the full financial impact of this year's crop on FY '22 results.

- Keep in mind that this is the second year that the company has experienced higher than normal potato costs. In response to the pandemic in fiscal 2020, the company held on to last year's potato crop longer than normal to save cash. As we discussed in past reviews, these older potatoes increased processing costs which built up in inventory and resulted in substantial hits to margins in the 8/20 and 11/20 quarters. Gross margin adjusted for unrealized hedging gains/losses fell to 19.5% for the trailing 12-month period ended 8/21 compared to 23.7% for the same period ended 8/20. Before that, gross margins typically ran in the 25-26% range. As the inventory situation clears itself and restaurant sales pick back up and leverage costs, a return to the 26% level over the next 12-18 months is, in our mind, a reasonable expectation.

- The company is implementing price increases to combat rising costs but is admittedly behind the curve. Price increases will benefit the second quarter, but the real benefit will not be seen until contracts roll over in the third quarter.

- Debt is manageable at just over 2x a normalized EBITDA of $900 million. When new capacity comes online, it should allow the company to boost EBITDA to over $1 billion and put the company in a position to retire around $300 million in debt annually. We could easily see 5% annual stock price appreciation just from shifting value from the debt to the equity holders even if the multiple remains flat.

- Market sentiment has clearly turned against LW and there could be more downside if management comes back with discouraging news about the potato crop in a couple of months. This is the key reason we are not making LW a Top Buy at this point. However, we believe it is a good bet that next year's potato crop will be much closer to normal, price increases will kick in, and dining out will pick at least by next summer. We don't think it will take the market a year to come to the same conclusion.

Explanation of EQ Rating Scale

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

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

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

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

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

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

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

Key Points to Understand About the EQ Score

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

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

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