BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers 4Q '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. 7
The Coca-Cola Company (KO)	3- (Minor Concern)	3/30/2022	p. 9
Conagra Brands (CAG)	2- (Weak)	10/8/2021	p.12
Colgate-Palmolive Company (CL)	3- (Minor Concern)	7/8/2022	p.15
The Hershey Company (HSY)	3- (Minor Concern)	7/8/2022	p.17
International Business Machines Corporation (IBM)	2- (Weak)	3/12/2021	p.19
Iron Mountain Incorporated (IRM)	1- (Strong Concern)	12/4/2020	p.22
Keurig Dr Pepper Inc. (KDP)	2- (Weak)	12/4/2020	p.25
Mohawk Industries, Inc. (MHK)	2- (Weak)	9/27/2022	p.27
Okta, Inc. (OKTA)	3- (Minor Concern)	9/26/2022	p.31
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	
Cintas Corporation (CTAS)	3- (Minor Concern)	12/2/2022	p.38
Mondelez International (MDLZ)	2- (Weak)	12/2/2022	p.39
Teva Pharmaceuticals Industries Ltd. (TEVA)	3- (Minor Concern)	12/13/2021	p.40

Top Values

Company	EQ Rating	Date Added	
Air Lease Corporation (AL)	4+ (Acceptable)	9/27/2022	p.42
Ares Capital (ARCC)	4+ (Acceptable)	12/2/2022	p.44
AT&T Inc.(T)	4+ (Acceptable)	3/12/2021	p.46
Costco Wholesale Corporation (COST)	*5+ (Strong)*	12/2/2022	p.48
LyondellBasell Industries N.V. (LYB)	*5+ (Strong)*	7/14/2021	p.50
National Instruments Corporation (NATI)	*5+ (Strong)*	3/12/2021	p.52
Starwood Properties Trust, Inc. (STWD)	*5+ (Strong)*	2/8/2022	p.54
Texas Instruments Incorporated (TXN)	*5+ (Strong)*	3/12/25021	p.56
United Rentals, Inc. (URI)	4+ (Acceptable)	12/13/2021	p.58

On Deck Values

Company	EQ Rating	Date Added	
Air Products and Chemicals, Inc. (APD)	4+ (Acceptable)	12/2/2022	p.60
Ball Corporation (BALL)	3- (Minor Concern)	9/27/2022	p.62
DocuSign, Inc. (DOCU)	4- (Acceptable)	7/8/2022	p.64
Otis Worldwide Corporation (OTIS)	5+ (Strong)	7/8/2022	p.66
The Scott's Miracle-Gro Company (SMG)	4- (Acceptable)	9/27/2022	p.69
Warner Bros. Discovery, Inc. (WBD)	3- (Minor Concern)	9/27/2022	p.70

Summary of Changes to the 4Q'22 BTN Focus List

Removed from Top Risks

General Mills, Inc. (GIS)	Removed 12/2/2022
Mondelez International, Inc. (MDLZ)	Removed 12/2/2022

Removed from On Deck Risks

Kyndryl Holdings, Inc. (KD)	Removed 12/2/2022

Added to On Deck Risks

Cintas Corporation (CTAS)	Added 12/2/222
Mondelez International, Inc. (MDLZ)	Added 12/2/222

Added to Top Values

Ares Capital (ARCC)	Added 12/2/2022
Costco Wholesale Corporation (COST)	Added 12/2/2022

Removed from Top Values

Air Products and Chemicals, Inc. (APD)	Removed 12/2/2022
Mowi ASA (MHGVY)	Removed 12/2/2022

Added to On Deck Values

Air Products and Chemicals, Inc. (APD)	Added 12/2/2022

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	$82.0 B
PE (fwd)	9.7
Short %	0.83%
Current EQ Rating	2- (Weak)

Altria's appeal is its 8.2% dividend ($0.94 per quarter) on its $46 stock price. Adjusted EPS was $1.28 in 3Q22, $1.26 in 2Q22, and guidance for 4Q22 of $1.15-$1.23 still looks like MO can support it.

However, we see that MO is already missing forecasts, its smoking income is essentially equal to the dividend and the smoking income has had tailwinds that are about to become headwinds at the same time volume decay is already accelerating. We do not see much cushion for the dividend going forward.

Consider the following issues:

- EPS in 2022 has picked up 2-3 cents per quarter because MO is not paying to roll out IQOS (Heated Tobacco) after its product with Philip Morris was banned in late 2021. This benefit to EPS will lap in 4Q22. Going forward, MO will be paying to roll out a new heated tobacco product with Japan Tobacco, so expenses will rise.

- Adjusted EPS is adding back litigation expenses as one-time events – even though litigation issues are increasing with JUUL. That was 2 cents of EPS in both 2Q and 3Q. We found another 2 cents of EPS gain in General Corporate expenses in 3Q that was litigation related.

- Repurchasing shares added 3 cents to adjusted EPS as well in 3Q and 2Q. Can MO continue to afford this too?

- Without those items, MO's y/y EPS is already declining, and MO missed forecasts in 3Q and lowered guidance for 4Q. Investors are still looking at EPS of $1.19 for both quarters vs. the $0.94 dividend and saying that's still only 79% of earnings.

Look at Free Cash Flow: The dividend of $4.9 billion consumed 89% of free cash flow of $5.5 billion so far in 2022. And, MO cannot afford share repurchases from free cash flow of $1.5 billion. The repurchases look likely to slow, which could impact EPS growth.

Now look at Smoking Income: This is 90% of MO's operating income at $1.7-$1.9 billion per quarter vs. the dividend of $1.7 billion.

- Smoking Volumes are plummeting due to inflation for food, rent, and gasoline prices. After a brief respite from decay during Covid, MO is seeing negative growth compounding y/y again:

Altria Cigarette Vol. Growth	4Q	3Q	2Q	1Q
2022		-10.0%	-10.0%	-8.0%
2021	-8.0%	-7.0%	-4.5%	-3.5%
2020	-1.0%	-1.0%	-2.0%	-3.5%
2019	-6.0%	-7.0%	-7.0%	-7.0%

- MO has offset volume decay with sizable price hikes to preserve smoking revenue – that is no longer happening in 2022 and people are trading down to cheap cigarettes. MO may not be able to boost pricing enough to offset volume losses:

MO Smoking Rev	3Q22	2Q22	1Q22
Pricing Growth	$480	$570	$411
Volume Decay	-$584	-$757	-$404

- Also, keep in mind that the collapse of JUUL was a benefit for smoking income in 2022. JUUL was cannibalizing cigarette volumes and revenues. However, MO was losing 100% of cash revenue and income from selling a pack of cigarettes vs. 35% of non-cash equity income on the sale of JUUL products. With JUUL sales down, some people switched back to normal cigarettes – and this helped smoking cash flow.

- When the new heated tobacco joint ventures roll out, MO will be losing 100% of its income on cigarettes and replacing that with 75% of the income on heated tobacco – that looks likely to hurt smoking volume and income further. Plus, heated tobacco will involve more marketing, promotion, distribution, and manufacturing costs – thus it should be less

profitable on the same volume before MO's share of the cut drops to only 75%. Losing $100 million of cigarette income may translate to only $80 million for the same volume of heated tobacco – then it falls to $60 million when MO only gets 75%. This type of situation should hit smoking income going forward.

- Over 30% of cigarettes are menthol-flavored. For MO, the figure is lower, but it is still a meaningful percentage of volume. California just banned menthol cigarette sales and the FDA is proposing it nationwide. That could lead to more lost volume too.

- Graphic packaging on cigarette packs showing the health impacts of smoking is coming in 2023. That has shown to be effective in cutting smoking rates in dozens of countries.

- The FDA is working toward lowering nicotine levels in cigarettes, and studies have shown that cuts smoking volumes too.

Cloudflare, Inc. (NET)

Date Added	7/8/2022
Market Cap	$14.7 B
PE (fwd)	Na
Short %	5.1%
Current EQ Rating	3- (Minor Concern)

NET is forecasting it can achieve a 20% adjusted operating margin over time. The adjustments involve adding back stock compensation as well as acquisition-related costs. In 3Q22, it reported an adjusted margin of 5.8% with non-GAAP EPS of 6 cents, which beat forecasts by 6 cents. We saw multiple problems with sustainability on this starting with guidance of 4-5-cents for 4Q – down from 3Q results:

- Cash spending on R&D and Marketing was flat sequentially for the first time. R&D was flat at $46.4 million from $46.2 million – as a percentage of sales that added 1 cent to EPS. Marketing was flat at $103.5 million from $103.9 million – as a percentage of sales that added 2.4 cents to EPS.

- Interesting to note, headcount was up for NET. Not only did the cash pay not rise for these employees, they also didn't get more stock compensation either. As part of the Area 1 acquisition, NET reported that it expected to report $300 million in additional stock pay. Yet, sequentially, R&D personnel were at $30.0 million vs. $27.8 million and Marketing personnel were down at $11.9 million from $12.9 million. Is NET expecting to reduce total pay per employee?

- NET picked up 1.0 cents from interest income as higher rates on its cash balance came in. That's a plus, but hardly an operating item.

- It picked up another 0.7 cents on other income FX gains/losses and 0.4 cents from rounding up results.

We are concerned by sales guidance coming in weak after the lowest quarter of sales growth in some time. NET is highlighting pricing pressure. This is tougher too because deferred revenue is up again – that should be helping future revenue:

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Sales Growth Seq.	8.3%	11.1%	10.0%	12.4%	13.1%	10.4%	9.7%
Def Rev Growth Seq.	11.1%	18.5%	13.2%	24.9%	14.7%	18.3%	25.9%
Sales	$253.9	$234.5	$212.2	$193.6	$172.3	$152.4	$138.1
Def. Revenue	$180.1	$162.7	$137.2	$121.2	$97.0	$84.6	$71.5
Days of Sales	65.3	63.1	58.2	57.6	51.8	50.5	46.6

Free Cash Flow remains negative despite high levels of stock compensation and Deferred Revenues. Free cash flow had been at -$100 million for 1Q22 and 2Q22 on a trailing-four-quarters basis. **Losing a terrible 3Q21's -$39.7 million figure from the four-quarters calculation, made 3Q22 into only a -$64.8 million figure for trailing 12-months free cash flow. Yet, NET still has $171.0 million in stock compensation in that figure and $76.2 million in deferred revenue.** We do not envision NET becoming free cash flow positive unless it pays people even more with stock and that may not be the best currency anymore.

The Coca-Cola Company (KO)

Date Added	3/30/2022
Market Cap	$270.2 B
PE (fwd)	25.6
Short %	0.81%
Current EQ Rating	3- (Minor Concern)

KO's non-GAAP EPS of $0.69 beat by 5 cents. The beat looks real based on a few accounting items we saw:

- The tax rate dropped and KO guided its forecast for taxes down 50bp after the quarter. 50bp was worth 0.4 cents.

- Depreciation and Amortization fell $55 million in dollar terms and 82bp as a percentage of sales – adding 1.5 cents to EPS.

- Bad debt reserves rose again by $7 million on a lower gross receivable total – it rose to 11.5% of receivables vs. 10.2% in 2Q (there is seasonality in that) but that was a small headwind.

- Advertising had been largely flat this year, until 3Q when it rose $278 million in dollar terms and 150bp – that is 3 cents of headwind.

Guidance was raised for 2022 by 2 cents for EPS, Organic Sales growth by 1% with a 1% larger headwind for FX. We would be concerned that SG&A leverage was heavily driven by a big FX headwind lowering overseas costs in dollar terms. That alone produced 5 cents of EPS in 3Q. That enabled KO to boost advertising by $278 million (which may be necessary with the pricing gains) while only reporting SG&A growth of $157 million with FX holding those costs down. It would not take much to see that SG&A figure start to grow rapidly if FX is more benign. KO's guidance is for FX headwinds to moderate in early 2023.

- Inventory remains very low in our view given where it was the last four years after 3Q. We still believe KO is delaying fully rebuilding its inventory in unit terms. This could be an area that hurts free cash flow as it costs more to purchase. It also represents a wildcard for gross margin – which is already down despite huge pricing gains:

	3Q22	3Q21	3Q20	3Q19
Inventory	$3,708	$3,182	$3,264	$3,266
Adj. COGS	$4,510	$3,908	$3,508	$3,717
DSIs	74.8	74.1	84.7	80.0
Gross Margin	59.2%	61.1%	59.4%	60.9%
Pricing	12%	6%	-3%	6%
FX	-8%	2%	-3%	-3%

- KO's gross margin fell by 190 bp. We'll grant that some of that is due to 3Q21's quarter getting price hikes and positive FX. But, gross margin is still below pre-Covid levels by 170bp. We see three headwinds coming in this area:

    - Average-Cost and FIFO inventory accounting both benefit from inflation and hurt during deflation. With the combination of big increases in pricing and expensing older (cheaper) inventory and not replacing it – we would expect gross margin to be rising. What happens if KO does need to stock up on more inventory at higher prices and/or the price hikes level off or decline? It doesn't even need to be a major change. 11% pricing vs. 12% would have cost KO 2 cents in EPS in 3Q22. Another 50bp of lost gross margin would be 1 cent.

    - Gross margin should already be benefiting from declining depreciation and amortization costs – that added 82bp y/y in 3Q22. Gross margin still declined. That level of that y/y drop is getting smaller now too. Taking away that tailwind could hurt EPS growth as well.

    - Latin America had been providing strong pricing and positive FX changes too. Now the FX headwind is back and growing. 3Q posted 18% organic growth vs. 34% a year ago. They have an easy comp for 4Q, but 1Q23 looks very tough again:

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

- 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	$17.7 B
PE (fwd)	15.5
Short %	1.9%
Current EQ Rating	2- (Weak)

CAG remains one of the best companies at guiding down and then beating easy forecasts. Any time it is above $35, we would advocate watching out for disappointment. The company's growth rate is poor at best and its greatest source of earnings gains has been cutting advertising and promotional spending, which it now expects to increase. In reality, margins are hitting all-time lows at this point even with huge commodity-driven pricing gains. It is already guiding to even weaker volume growth for fiscal 2Q23 and is blaming supply-chain issues:

	1Q23	1Q22	1Q21	1Q20	1Q19	1Q18
Pricing	14.3%	1.6%	4.1%	0.8%	1.2%	2.2%
Volume	-4.6%	-2.0%	10.9%	-2.5%	0.0%	-5.3%

Adj Oper. Margin	f23	f22	f21	f20	f19	f18
1Q	13.7%	14.1%	20.2%	15.7%	14.6%	15.4%
2Q		14.6%	19.6%	17.1%	17.5%	16.7%
3Q		13.7%	16.0%	15.7%	16.3%	15.0%
4Q		15.0%	14.0%	17.1%	13.2%	13.0%

- The first thing to watch out for from CAG is it wants to compare current results to Pre-Covid levels. (For CAG 4Q20 was the first quarter of Covid). But many forget that just before Covid, CAG was watching its large acquisition of Pinnacle Foods blow up and as sales and margins collapsed it told investors it would take years for them to rebuild Pinnacle's products and top-line. Here are the growth rates it was showing at the time and why it wants to compare current results to these low standards:

	4Q20	3Q20	2Q20	1Q20
Pricing	0.5%	-0.4%	0.6%	0.8%
Volume	21.0%	-1.3%	1.0%	-2.5%

- 1Q23 (ending in October) showed the standard CAG story with results. It beat by 5 cents and then DID NOT raise guidance. It had led investors to expect:

  - Advertising would rise but it came in below last year's level. It further reported that promotional spending which lowers net sales came in at record-low levels. That helped margins, sales, and EPS. This added at least 1 cent.

  - Its milling JV was supposed to see moderating results per CAG guidance in 1Q23. Instead, it came in with nearly the highest profit ever which added about 5 cents to EPS:

Equity Method Income	4Q	3Q	2Q	1Q
fiscal 2022	$47.5	$48.1	$29.5	$20.2
fiscal 2021	$33.4	$21.5	$23.0	$6.5
fiscal 2020	$22.9	$10.4	$27.6	$12.3

  - CAG guided to a 24% tax rate and came in below that adding 0.7 cents and depreciation fell $3.4 million adding 0.5 cents.

- We think as CAG cuts volume forecasts for 2Q23 and blames supply chain issues, investors should be asking, "How is CAG carrying really high inventory levels amid these supply-chain problems?" We think the high inventory levels should pressure pricing and margin:

Inventory DSIs	F23	f22	f21	f20
1Q	92.8	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

- ROI is only about 9% here and they are already shedding volume again before their forecast of weaker volume for 2Q23. CAG touts its valuable brands but has frequently taken write-offs on these assets. We noted that 1Q23 saw an impairment on *Birds Eye* of $244 million and a $141.7 million write-down of goodwill for its refrigerated & frozen division. This comes after $209 million of write-downs in fiscal 2022. Management blamed the first quarter impairments on using a discount rate that rose to 7.75%. CAG still has

$11.2 billion in goodwill and $3.6 billion in other intangibles. How much of those assets are at risk if CAG uses an 8%-10% discount rate?

Colgate-Palmolive Company (CL)

Date Added	7/8/2022
Market Cap	$63.5 B
PE (fwd)	26.1
Short %	1.1%
Current EQ Rating	3- (Minor Concern)

One of our biggest concerns with CL is its pattern of barely meeting earnings expectations with help from unsustainable items in the last few quarters. The third quarter was no exception as it beat the consensus estimate by a penny but we noted several one-time benefits which may reverse:

- Other Expense (Income) after adjustments rose to $5 million of income versus $18 million in expense adding 2.4 cps to earnings in the period. The 10-Q indicates that the largest source of the improvement was due to a VAT refund in Latin America in Q3 22.

- Advertising declined on an absolute basis and fell 50 bps as a percentage of sales, adding 2 cps to earnings growth. On the call, management attributed this in part due to supply chain issues at Hill's that hampered shipments and weaker sales om Europe which led to delays in the advertising spend. In the second-quarter call, the company stated that it expected advertising to increase in the second half and remain relatively flat as a percentage of sales. This makes us believe that the absolute decline and associated boost to EPS was unexpected. If the company does not compensate with much higher advertising in the fourth quarter, we will consider that a significant red flag.

- The allowance for bad debts fell to 4.5% of gross receivables. The reserve percentage has been declining since the buildup of reserves during Covid but is now below the more normal pre-pandemic rate of over 5%. We estimate it would take about a penny per share in expenses to rebuild the reserve percentage to the pre-pandemic level and could be a larger headwind if a slowing economy forces the reserves to be built higher.

Other Items of Concern

- Inventory DSIs rose to 100 days from 86 in the year-ago period and were significantly higher than the mid-to-high 70s range seen before the pre-pandemic. This may be

beneficial in the short run if it helps the company in fulfilling orders. It may also benefit from selling older, lower-cost inventories at higher prices. However, this needs to be monitored going forward for signs of overbuilding. Some commodities are already coming down in price which may make future price increases more difficult to push through. Looking forward, FIFO companies that build excess inventories at today's higher costs may see margin pressure when price increases falter. CL uses FIFO for 75% of its inventories

- We have warned in the past that a disproportionate share of the company's growth is coming from premium pet care products in the Hill's pet nutrition segment. Volume growth had been running in the mid-teens rate despite price increases of similar amounts. However, the 9/22 quarter saw volumes fall by 3.5% on only 7% price increases. The company said that the lower-than-expected sales were a result of supply chain problems. This should be closely watched in the fourth quarter for further signs of weakness.

- Likewise, Latin America has been a key source of growth, with volume tracking fairly steady despite pricing boosting growth in the 7-12% range. However, pricing jumped by 20% in the third quarter resulting in an 8.5% drop in volumes. Meanwhile, FX returned to a drain on reported sales growth of 4.5%. All of this makes us believe Latin America could be a source of disappointment in upcoming quarters.

- The erosion from foreign currency translation also worsened in Asia Pacific (-8%) and Africa/Eurasia (-9%). As with Latin America, the company compensated for the weaker FX rates by increasing prices by 26% in Africa/Eurasia. This is resulting in overstated organic growth rates which remove the negative impact of FX while maintaining the benefit of the unusually high price increases. To put this in perspective, if we assume pricing increased by 15% in Latin America instead of 20%, the company's total organic growth rate falls to 5.9% from the reported 7.0%. Assuming Africa/Eurasia pricing increased 20% instead of 26 further reduced total organic growth to 5.6%.

The Hershey Company (HSY)

Date Added	7/8/2022
Market Cap	$47.3 B
PE (fwd)	28.5
Short %	1.8%
Current EQ Rating	3- (Minor Concern)

Bulls love HSY as they see consumers continuing to spend on $2 candy bars as a treat even if inflation and a slowing economy continue to squeeze budgets. However, we are concerned that the low level of the company's inventory may be indicating unexpected pressure on future margins as it replenishes at higher costs.

HSY reported non-GAAP EPS of $2.17 in 3Q22. This was 7 cps ahead of the consensus while revenue came in over $110 million above targets. The company also raised both its sales and non-GAAP EPS growth forecasts for the full year to 14-15% from the previous 12-14% range. The mid-point of the EPS growth range was increased by only 11 cps after a 7 cps earnings beat, so the raise was far from dramatic.

- Key to the beat was stronger than expected volume growth as a result of better elasticities than expected. Volumes improved by 4% in the quarter despite a 7.7% increase in pricing. The 4% volume growth benefitted by 2% from earlier seasonal shipments and 1% from the benefit of inventory replenishment by retail customers. Management admitted that the retail replenishment was higher than it anticipated but still contended that base volumes were about what they expected.

- The pricing increase of 7.7% was a reduction from the 9.5% pricing growth in the second quarter. This was likely weakened by the impact of promotional spending which management said has returned to normal levels after supply chain disruption led to lower promotions in the second quarter. After the second quarter, the company was looking for "volume declines in the second half of the year". Management admitted it expects these elasticities to weaken in 4Q22 so a volume decline in the next quarter looks likely. Still, we don't think there is any getting around the fact that third-quarter volumes were higher than anticipated.

- Inventory DSIs fell by 2.4 days to 68.7 days. We have been highlighting this lagging inventory growth for several quarters. Pre-Covid, DSIs in a third quarter were often in the mid-70s. The raw materials component of inventory was the center of the decline, falling

to $361 million from $391 million in 2Q22 and over $400 million in the year-ago quarter. Factoring in inflation, this implies a significant decline on a unit basis.

Inventory Component Data	10/02/2022	7/3/2022	4/3/2022	12/31/2021	10/3/2021	7/4/2021	4/4/2021
Raw Materials	$360.789	$390.557	$383.557	$395.358	$403.374	$412.728	$428.678
Goods in Process	$148.837	$164.444	$150.722	$110.008	$131.523	$140.868	$116.894
Finished Goods	$862.556	$841.036	$685.022	$649.082	$662.073	$677.254	$534.660
Adjustments to LIFO	-$187.797	-$187.798	-$187.798	-$165.937	-$170.429	-$170.428	-$170.430
Total Inventory	$1,184.385	$1,208.239	$1,031.503	$988.511	$1,026.541	$1,060.422	$909.802

- HSY records its LIFO provision in the fourth quarter. Management appeared to positively adjust its forecast for gross margin for the full year to “down 120 bps” from its previous range of “down 120-140 bps.” However, a larger LIFO charge from rebuilding inventory at higher prices may make hitting the gross margin target difficult. Gross margin coming in 20 bps lower than expected would cost the company about 1.8 cps.

- The company stated that advertising and related consumer spending increased by 5.4%. This is roughly in line with the volume increase of revenue. However, given the likely pressure on volume in the fourth quarter from a weakening consumer footing and increased pricing, HSY may need to bump up advertising and promotional activity to avoid weak volumes in 4Q.

International Business Machines Corporation (IBM)

Date Added	3/12/2021
Market Cap	$132.5 B
PE (fwd)	16.5
Short %	3.4%
Current EQ Rating	2- (Weak)

IBM regularly reports poor-quality quarters littered with unsustainable non-operating benefits. We believe the company's results do not adequately reflect its development spending which it obtains largely from acquiring IP from other companies and then adding back the associated amortization to non-GAAP profits. It is also alarming that a large part of revenue growth comes from selling more to its spun-off Kyndryl business which itself is seeing revenues decline. All of these items continued into the third quarter. IBM's adjusted 3Q22 EPS of $1.81 beat by only 1 cent and was down y/y from $1.84. We see several areas where IBM picked up some short-lived earnings and past contributors to earnings are now headwinds.

- Depreciation declined at IBM from $1.037 billion to $586 million in 3Q. We know Kyndryl's depreciation from 3Q21 was $389 million, meaning IBM picked up $62 million in earnings from lower depreciation. That was 6 cents of EPS in 3Q22.

- On that same theme, we believe IBM is continuing to under-invest in capital spending and software. These figures continue to decline y/y:

	3Q22	3Q21	2Q22	2Q21	1Q22	1Q21
Capital Spending	$317	$351	$339	$560	$281	$494
Cap. Software	$138	$176	$172	$204	$169	$175

- IBM saw workforce rebalancing charges become a headwind as we predicted, posting $13 million in expense vs. 3Q21's $0, which cost EPS 1 cent. IBM has a big headwind coming in 4Q, the $60 million credit added 6 cents to 4Q21's EPS:

Workforce Rebalance	4Q	3Q	2Q	1Q
2022		$13	$28	$5
2021	-$60	$0	$107	$94

- IBM also saw bad debt expense continuing to rise as 3Q21 was a credit of $17 million and 3Q22 was an $11 million charge. The $28 million swing cost IBM 2.6 cents.

- But, against the headwinds from workforce rebalancing and bad debt expense, IBM cut advertising by $45 million, which added 4 cents, and cut stock compensation by $11 million, which added 1 cent too. Those areas offset the workforce charges and bad debt headwinds for a net 1.4 cents of tailwind.

- IBM boosted the gain on the sale of the health care data and analytics unit from earlier this year from $232 million to $259 million in the 3Q22 – that $27 million added 2.5 cents to EPS.

- IBM saw a big leap in recognizing deferred revenue on extended warranties in 3Q22. This account has been shrinking and has been about a 1-cent headwind for income per quarter, it suddenly became a positive for 0.6 cents last quarter:

Ext. Warranty	3Q22	3Q21	2Q22	2Q21	1Q22	1Q22
New Deferral	$19	$21	$66	$32	$18	$18
Amortized Deferral	-$57	-$50	-$39	-$51	-$44	-$53
Balance	$284	$334	$339	$367	$323	$383

- Other income was up y/y from $74 million to $293 million in 3Q. That includes the $27 million gain from selling the healthcare unit and $39 million in higher interest income due to rising rates. That still leaves a $153 million net increase which is 14 cents of EPS, and is largely gains on FX contracts. We're not going to call this out as a major issue other than this is not operating income. Also, IBM carefully calls out every place where FX is a headwind for it, but doesn't spend much time pointing out the hedges offsetting it.

- IBM had virtually flat R&D despite inflation and higher sales. As a percentage of sales, IBM dropped 94bp, which could have added as much as 12 cents to EPS. The only explanation in the 10-Q is that FX offset some of the R&D expense growth. Given that R&D only rose 0.3% against operating revenue growth of 8.4%, we think it is fair to believe IBM is picking up a few cents in EPS by not growing R&D.

- We wonder what happens as the new Z-System roll-out matures. This revenue stream is incredibly volatile:

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

The bold figures are Z-systems growth, the non-bold figures are the full systems unit's growth rate and Z-systems were called out as leading the full unit. It looks like 4Q is another easy comp, then it may be tougher to see more growth.

- Kyndryl is still a big part of IBM's growth. It appears IBM is getting a larger share of a negative growth business. In 3Q22, Software at IBM was up 7%, 14% without FX, and 8% was to KD. For Infrastructure, IBM was up 15%, 23% without FX, and 9% was to KD. Areas in those units look almost completely reliant on KD. Transaction processing grew 23% with 26% due to KD. Infrastructure support grew -3% with 7% growth from KD.

Iron Mountain Incorporated (IRM)

Date Added	12/4/2020
Market Cap	$15.8 B
P/FFO (fwd)	19.0
Short %	6.1%
Current EQ Rating	1- (Strong Concern)

IRM's 3Q22 met forecasts of $0.76 for FFO. Its AFFO came in at $0.98 and guidance did not change. We think price increases on storage have been the only real source of growth here. In 3Q, volume growth was less than 1% with a small amount of acquisition and 9% from price increases. Every 1% of pricing adds 2.5 cents to AFFO, which was only up 8 cents y/y.

We also noted that the service revenue growth, which had been recovering from Covid – dropped off again in the quarter. It dropped from $536.4 million in 2Q to $526.6 million in 3Q. Comps in this area are getting tougher:

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

As is normal for IRM and its AFFO, there were a number of items that added back to the figure that are either not sustainable in our view or are actually cash costs that IRM ignores in the computation:

- IRM cut bad debt reserves again to 4.4% - adding 1.2 cents
- Capital payments on financing leases were $9.2 million and were omitted – adding 3.1 cents
- IRM lives via acquisition and restructuring acquisitions and added back less than 2Q, but still boosted AFFO by 2 cents here

- Cash inducement payments and fulfillment costs are cash expenses. AFFO capitalizes them and then adds back the amortization. We look at the actual cash payment every quarter and AFFO was inflated by 5.9 cents in 3Q

- Maintenance spending for AFFO did rise slightly and was a 0.3-cent headwind

- Non-cash rent expense was added back again for 1.9 cents and IRM's estimate of what rent could be added 0.6 cents

- Stock option expense was added back for 4.9-cents

Just those items would reduce the $0.98 in AFFO by over 19 cents in 3Q. That's in addition to some portion of pricing increases that may be tough to continue.

Again, we see that AFFO does not come close to approximating actual cash flow:

	3Q22	3Q21	2Q22	2Q21	1Q22	1Q21
AFFO	$288.0	$264.2	$270.9	$264.2	$184.4	$181.0
Cash from Ops	$214.4	$74.1	$291.4	$320.4	$54.5	$68.8
Capital Spending	$266.6	$123.4	$169.1	$150.1	$161.1	$145.5
Acquisitions	$5.6	$168.0	$0.8	$35.7	$717.9	$0.0
Pymts for Business	$17.3	$17.2	$22.5	$17.4	$16.2	$19.1
JV Investments	$0.0	$0.0	$0.0	$56.6	$0.0	$6.5
Cap Lease Pymts	$9.2	$11.7	$9.7	$11.2	$10.4	$12.4
+ Sale Leasebacks	$22.9	$5.2	$91.1	$197.3	$5.4	$12.4
Free Cash flow	($61.4)	($241.0)	$180.4	$246.7	($845.7)	($102.3)
Dividend	$179.9	$179.1	$179.8	$178.8	$184.4	$181.0

The latest effort to grow at IRM will cost $4 billion – we don't see much of that cash coming internally. The only time IRM has covered its dividend in recent years was 2020 when cash costs were very low for fulfillment and it did $565 million in sale-leaseback transactions.

The debt figure is rising. We continue to add in the deferred purchase obligation of $275 million to get net debt of $10.16 billion. We use IRM's definition of EBITDA with only two changes. We subtract the cash costs of obtaining business and fulfillment as well as capital payments on

financing leases, so that makes EBITDA $1.67 billion and a ratio of 6.24x. Some of the $4 billion they plan to spend expanding looks likely to be borrowed too.

Keurig Dr. Pepper Inc. (KDP)

Date Added	12/4/2020
Market Cap	$54.0 B
PE (fwd)	22.9
Short %	2.2%
Current EQ Rating	2- (Weak)

Wall Street sees KDP as a safe consumer staple that is paying down its debt. However, we believe most do not appreciate the degree to which the company has simply transferred its term debt to its accounts payable which results in a meaningful amount of leverage being ignored by investors looking at traditional metrics. With rates rising, this seems likely to reverse. Meanwhile, the company continues to meet forecasts with unusual non-operating benefits. KDP has hit forecasts on the nose for the last four quarters. For 3Q22, adjusted EPS was $0.46. Y/Y EPS growth was only 1.8 cents or 4%. The company has refinanced some debt, but neither the total amount of debt nor the interest rate has changed much. Yet, the adjusted interest expense has dropped noticeably in 3Q22:

- Debt levels are down only slightly as KDP issued $3.0 billion of new debt and repaid $3.1 billion of existing debt in April 2022:

	3Q22	2Q22	1Q22	4Q21
Financed Debt	$11,561	$11,555	$11,584	$11,882
Adj. Interest Exp.	$89	$107	$111	$112

- We looked at the interest rate on the debt that was retired and the amount – it annualized to $144.2 million. The new debt issued has an annual interest expense of $125.7 million. So there should be some savings of $18.5 million. That would be basically $4.6 million per quarter in lower interest expense.

- 4Q21 and 1Q21 had the old debt outstanding so some modest debt repayment lowered the adjusted interest expense by $1 million – that looks fine. The refinancing happened in the first month of 2Q, debt is flat overall, and interest expense drops $4 million – that looks fine.

- How did it drop to $89 million in 3Q22? We would have expected $104-$106 million. The debt levels and the interest rates are the same as 2Q22. There were derivative mark-to-market unrealized losses of $113 million that KDP added back in 3Q. But when we run the numbers on their debt, we see only a total savings of $18.5 million for the year, how did KDP pick up $22 million in one quarter from 1Q22?

- We think interest expense should have been $105 million, so this added $16 million in adjusted income or 1 cent to adjusted EPS.

- We also saw KDP ignored financing lease payments which rose $9 million y/y and added 0.5 cents to adjusted EPS and their Covid payments (yes here in September of 2022 – KDP is still adjusting for Covid payments) went up y/y – and added another 0.3 cents to adjusted EPS.

- We're not convinced that KDP can continue taking pricing like they are: Up 7.8% for coffee with lower volumes especially for brewers down 15.3%, up 13.6% for packaged beverages, up 16.6% for beverage concentrates and up 17.3% in Latin America with only a -1.9% FX headwind. If pricing only came in at 1% lower – it would have cost KDP 1.8 cents in EPS and results would have been flat y/y.

- The potential payables interest rate time bomb keeps ticking. KDP had $3.9 billion in payables outstanding that its customers have factored with banks. That allows KDP to push its payables to $5.3 billion and 297 days outstanding. If you want to see how KDP is "repaying" its fixed debt – here's the answer. Bloomberg screens do not count payables as debt. Payables are up $1 billion YTD so far. 3-month rates are 4.5%-4.7% now vs. 20bp a year ago. Customers are paying $175 million now to carry KDP. How long can that last? And if there's a company that doesn't have $4 billion in cash laying around it's KDP. Debt to EBITDA is 2.7x according to management. If we add in the structured payables plus the $3.9 billion of other payables that are factored, the debt is really 3.75x. If KDP simply had to borrow another $4 billion at 5% to settle with suppliers and unwind the factoring, it would knock 11cents off annual EPS.

Mohawk Industries, Inc. (MHK)

Date Added	9/27/2022
Market Cap	$6.4 B
PE (fwd)	7.8
Short %	3.3$
Current EQ Rating	2- (Weak)

We continue to view MHK's earnings as poor quality given they are regularly littered with material unusual benefits and regular restructuring charges added back to non-GAAP earnings. The company just met earnings estimates in the 9/22 quarter despite missing the top-line targets by almost $100 million. Management noted that revenue fell below their expectations due to softening demand in the retail channel as inflation squeezed consumers while retailers trim their inventories. We noted multiple non-operating benefits to EPS in the quarter that prompt us to maintain our 2- (Weak) earnings quality rating.

- MHK's non-GAAP tax rate was 17.9% versus 21.4% a year ago. The company was guiding to a full-year tax rate of 21%-22% after the second quarter following it posting tax rates of 22.3% and 22.0% in the first two quarters of the year. We believe it is fair to say that analysts were expecting the tax rate to be closer to 21%. The lower-than-expected rate added about 14 cps to earnings in the quarter. The company is now forecasting a 20% tax rate for Q4 and a full-year rate of 21%.

- The Allowance for Discounts, Claims, and Doubtful Accounts as a percentage of gross receivables remained essentially flat sequentially at 3.8%. However, this is still down from the mid-4% range seen pre-pandemic. We estimate it would take more than 15 cps in expense to return the allowance to that level.

- The warranty reserve also remained relatively flat sequentially both absolutely and as a percentage of sales. However, we still estimate it would take more than 10 cps in expense to return the warranty reserve to a more normal level closer to 2%

- Other income jumped from essentially zero last year to $1.2 million in the third quarter as an increase in foreign currency losses was more than offset by "the favorable net impact of other miscellaneous items of approximately $4 million." The $4 million beneficial swing added 5 cps to earnings in the quarter.

- The amortization of costs to obtain contracts continued to fall as a percentage of average capitalized balances. As we have discussed in past reviews, this percentage has been declining for several quarters which may be indicating a longer amortization period for newer capitalized costs. If the percentage had remained constant with the levels seen in 2021, it would have shaved more than 2 cps off earnings.

- A decline in stock compensation added about 1.5 cps.

- Inventory DSIs jumped to over 121 days, an almost 20-day increase from a year ago. Recall that the company's inventories were depleted by heightened demand during the pandemic and it has been scrambling to rebuild inventory levels ever since, even complaining in recent quarters that lower inventory levels were costing it sales. In the third-quarter conference call, the company attributed 75% of the absolute increase to inflation with the rest due to acquisitions. It also noted it will be reducing production in the fourth quarter. With DSIs now above pre-Covid levels by a few days, we will be concerned that continuing increases will be signaling an unplanned buildup of inventory at higher costs heading into a period of lower demand.

- MHK added back $35 million (44 cps) in restructuring charges related to new restructuring actions. Total charges are expected to be $90-$95 million but related largely to retiring higher-cost assets. As a result, cash costs will be only $15-$20 million which makes these amounts less concerning than the typical charges we see. However, restructuring charges are a regular feature of MHK's results which weaken the earnings quality in our view.

- The company took a $688 million pretax charge to write down the value of goodwill as a decline in its MHK's market cap, challenging market conditions, and higher discount rates led to a decline in the fair value of the assets.

- The company added back $45 million in "legal settlements and reserves" to non-GAAP results. We saw no explanation of what this was related to in the 10-Q, press release, or conference call. The company currently faces civil class action lawsuits as well as federal and state actions related to serious allegations of issuing false and misleading statements in 2017-2018 to hide the buildup of faulty inventory and inflate sales through the timing of deliveries. It also has cited PFC litigation in its SEC filings.

Okta, Inc. (OKTA)

Date Added	9/26/2022
Market Cap	$8.5 B
PE (fwd)	Na
Short %	5.8%
Current EQ Rating	3- (Minor Concern)

OKTA wowed the market with fiscal 3Q23 (ending in October) adjusted EPS of $0.00, which beat forecasts by 24 cents. We're not too sure about the quality of this beat:

- Adjusted R&D spending has now declined in dollar terms for both 3Q23 and 2Q23. OKTA is saying headcount is up in every quarter. Normally, adjusted R&D is about 22% of sales. We can accept some level of margin leverage with sales growth, but sales growth is decelerating here:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
Revenues	$481.0	$451.8	$414.9	$383.0	$350.7	$315.5
Sequential Growth	6.5%	8.9%	8.3%	9.2%	11.2%	25.7%
Adj. R&D Exp.	$79.3	$85.8	$92.5	$84.5	$73.6	$68.7
Adj. R&D % Sales	16.5%	19.0%	22.3%	22.1%	21.0%	21.8%

  2Q22 was when the large acquisition happened. The R&D guys are taking home smaller dollar paychecks now. **Had this spending stayed at 22% of sales, OKTA's adjusted EPS would be 17 cents lower.** OKTA makes no mention of FX impacting this like IBM does.

- To make matters worse, OKTA cannot even say it boosted R&D's pay with more stock compensation – which doesn't impact adjusted results. That's down in dollar terms too:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
Stock Comp for R&D	$69.2	$70.1	$69.2	$63.0	$56.9	$53.7

  We would expect to see this figure rising since OKTA adds it back anyway to non-GAAP EPS. That's one of the key levers to producing non-GAAP income.

- **Interest income rose with interest rates by $3.2 million and added another 2 cents to EPS.** That's not a surprise, but hardly an improvement to operating income.

- Adjusted gross margin bounced up to 78.0%. OKTA doesn't address the adjusted margin, but for GAAP margin says this is due to economies of scale from higher sales. **100bp improvement added 3 cents to adjusted EPS**. The problem we have is this type of bounce never happened before and it happens now as sales growth slows:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
GAAP gross margin	71.4%	69.5%	68.4%	68.8%	68.7%	68.0%
adj gross margin	78.0%	76.8%	76.1%	76.8%	76.9%	76.5%

- OKTA also changed the definition of non-GAAP earnings in this quarter. From the 10-Q report:

"We define Non-GAAP operating income (loss) and Non-GAAP operating margin as GAAP operating loss and GAAP operating margin, adjusted for stock-based compensation expense, non-cash charitable contributions, amortization of acquired intangibles, acquisition and integration-related expenses and restructuring costs related to lease impairments in connection with the closing of certain leased facilities. Acquisition and integration-related expenses include transaction costs and other non-recurring incremental costs incurred through the one-year anniversary of transaction close.

Beginning in the third quarter of fiscal 2023, we updated our definition of Non-GAAP operating income (loss) and Non-GAAP operating margin to include restructuring costs as defined in the preceding paragraph."

In the 3Q23, OKTA reported its first restructuring charge to add back to adjusted EPS of $14.2 million and amounted to 9 cents of adjusted EPS.

- Free cash flow turned negative in 3Q23 even with a huge stock compensation figure being added back. We show this table often:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
T12 Free Cash Flow	($2.4)	$25.3	$45.7	$87.5	$114.9	$123.1
T12 Stock Compensation	$669.6	$654.4	$670.9	$565.5	$464.0	$361.9
Stock Comp % of Free Cash Flo	n/a	2585.3%	1468.6%	646.5%	403.7%	293.9%

- Another issue hurting cash flow is deferred revenue growth has slowed. OKTA started the year at 239 days of sales in deferred revenue, it's down to 203.

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
Deferred Rev.	$1,062.5	$1,011.3	$971.3	$996.2	$777.9	$737.3
Sales	$481.0	$451.8	$414.9	$383.0	$350.7	$315.5
Def. Rev. Days of Sales	203	206	208	239	204	215

Post Holdings, Inc. (POST)

Date Added	3/30/2022
Market Cap	$5.4 B
PE (fwd)	27.3
Short %	4.3%
Current EQ Rating	3- (Minor Concern)

POST is carrying $5.8 billion in debt after its latest and final exchange of Bellring shares for some of its debt. That puts debt at 5.6-5.9x forecasted adjusted EBITDA. Servicing that $5.8 billion, POST has minuscule free cash flow of only $129 million in fiscal 2022 and $171 million in fiscal 2021. Free cash flow has been helped by POST NOT replacing inventory. We estimate they are light about 12 days or a $150 benefit to free cash flow. On top of that, POST has conditioned investors to expect that the company will grow via acquisition – yet its ROI was only 6.3% for fiscal 2022 and has averaged about 6% for years. How can it afford to make deals and borrow money at rates that are likely well above 6% now and make such meager returns?

We also estimate that hefty price increases that exceeded raw material, freight, and manufacturing cost growth drove ROI to 6.3% in 2022 instead of 5.7%. Plus, cuts to marketing added another 20bp.

Earnings quality remains very poor in our view as well despite beating fiscal 4Q22 (ending in September) estimates by 15 cents:

- POST cuts advertising regularly and now spends less than it did during Covid. For 4Q, the y/y cut was $5.3 million or 7 cents of EPS. For 3Q, the y/y cut was $6.5 million or 8 cents of EPS. (This is also helping free cash flow).

- POST added back costs associated with damaged assets that it expects to be indemnified for. It recorded 5 cents of income in 3Q and pulled it out of adjusted EPS and in 4Q, it recorded 7 cents of expense in this area and also adjusted it out of EPS. But the two figures didn't match- it is a net two cents of loss here that it didn't let impact adjusted results and never before has this been a line item.

- POST is carrying almost no bad debt reserve. It is at $2.3 million or 42 bps of receivables. Having this bad debt allowance at even 1% would have cost POST 4 cents in EPS.

- R&D was cut again by $3 million which added 4 cents to full-year 2022 EPS, or perhaps 1 cent per quarter.

- POST has stopped reporting its spending on repairs in the 2022 10-K. Repairs were $149-$163 million per year between 2017-2019. POST cut them to $140 million in 2020 and to $135.6 million in 2021. There was no mention of a surge in spending in 2022. If POST has been running $10-$15 million light in this area for the last three years, that is adding 3-5 cents to quarterly EPS and seems unlikely to be sustainable for long. (This is also helping free cash flow)

- POST is repurchasing shares to boost EPS growth, but it is borrowing some of the money to do this. With an ROI of 6%, we doubt this can continue amid higher interest rates. That added 1 cent in 4Q22.

- For 4Q, pricing jumped by 18% (largely driven by egg inflation). If that increase had been 17%, it would have cost POST 20 cents in EPS. For 3Q, pricing was up 16% y/y. If pricing had been up only 15%, it also would have cost POST 20 cents in EPS. The company is not far from missing forecasts badly.

- We look at how much pricing exceeded cost growth for raw materials, higher manufacturing costs, and freight costs. For 3Q, pricing growth exceeded cost growth by $17 million or 22 cents of EPS. For 4Q, pricing growth exceeded cost growth by $85 million or $1.05.

- POST just posted adjusted EBITDA of $280 million in 4Q and $251 million in 3Q – yet guidance for fiscal 2023 is only $990-$1040 million. It doesn't look like POST expects all this pricing to hold.

Sealed Air Corporation (SEE)

Date Added	12/4/2020
Market Cap	$7.5 B
PE (fwd)	13.0
Short %	1.6%
Current EQ Rating	2+ (Weak)

SEE showed investors all they need to know about their earnings quality. After beating forecasts by 8 cents in 3Q22 and by 32 cents YTD, the company cut guidance for sales, free cash flow, EBITDA, and EPS forecasts to levels below what they were forecasting at the start of the year.

On top of that, the initial guidance for the year called for 2 million more shares outstanding than new guidance – so SEE added 5 cents right there and the tax rate forecast is lower – adding another 3 cents there. That alone should have EPS guidance 8 cents above the start of the year yet it's flat.

Some of the tailwinds reversed on SEE in the 3Q that had been helping EPS – but not nearly enough to justify this much of a cut to forecasts:

- Inventory reserves rose $5.5 million costing it 2.8 cents
- Share compensation rose $3.3 million costing it 1.7 cents
- A higher tax rate cost it 0.8 cents
- That was offset by realized FX gains helped by $4.8 million of 2.4 cents
- And helped by adding back consulting fees for 0.8 cents
- The net is a headwind of 2.1 cents
- SEE is blaming China lockdowns for cutting volume – but that was known in 2Q and SEE was not cutting guidance then. Also, Asia isn't losing volume. Where SEE is getting beat up on volume is North America after it took some huge pricing gains:

	Americas	EMEA	APAC
3Q Price	14.2%	12.1%	5.6%
3Q Volume	-9.2%	-5.6%	-0.9%
2Q Price	20.1%	11.9%	9.6%
2Q Volume	-5.2%	-5.8%	-0.5%
1Q Price	21.4%	10.0%	3.2%
1Q Volume	-1.4%	1.0%	0.5%

- Lower volume unwinds margin leverage. We also see a big inventory problem building for SEE. It uses FIFO accounting so inflation should be helping its margins. Now some of the commodities it uses are declining in price and SEE ballooned its inventory up. They could be in a position where they have to sell high-cost inventory at lower prices. DSI's for inventory are normally 70 days. They were 87 in 2Q22 and 92 in 3Q22.

- SEE also changed their presentation of Price/Cost in the 3Q without explanation. This almost always is a red-flag as it makes tracking changes in operations more difficult. It is important to remember that Price/Cost is normally a +/- $10-$25 million item that is supposed to rise and fall with commodity prices – it can be negative. Customers will expect SEE to lower prices as commodities decline – look at how far ahead of $0 SEE has been of late:

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

- The new presentation now includes some additional operating costs that are not commodity related in the mix. It looks like SEE took even more pricing in 3Q22 compared to 2Q22 – but we only have three quarters of data for this new change in reporting:

	3Q22	2Q22	1Q22
Net Price Realiz	$71	n/a	n/a
Price/Cost		$114	$98
Higher Op. Costs	_	-$58	-$30
Net Pricing	$71	$56	$68

- The higher inventory, the lower volume, the lower volume forecast, and the enormous level of excess pricing SEE has taken this year – looks like there could be a sizeable reversal on sales, margins, cash flow, and EPS in 4Q and 1Q23.

Sysco Corporation (SYY)

Date Added	6/11/2021
Market Cap	$43.1 B
PE (fwd)	20.8
Short %	2.5%
Current EQ Rating	3- (Minor Concern)

We see regular red flags in SYY's reported earnings including unusual benefits, never-ending charges added back to non-GAAP results, and frequent changes to key disclosures. We believe this makes SYY vulnerable to an earnings miss in upcoming quarters.

SYY reported non-GAAP EPS of $0.97 in the 9/22 quarter which fell 2 cps short of analysts' estimates although revenue topped the consensus by over $425 million. Management maintained its outlook for the full fiscal year ended 6/23. However, we saw multiple items of concern in the quarter:

- SYY has historically disclosed the case volume growth is its US Broadline sales. However, it began including the case volumes from its US FreshPoint produce operations and its US Italian Business in the 9/22 quarter. These specialty businesses have seen their growth boosted by meaningful acquisitions made in the last few years. Comparing the historical volume figures restated for the new method to the actual reported historical volumes shows that the new method is adding anywhere from 4% to 16% to case volume growth. **With this in mind, it is possible that US Foodservice case volume growth was closer to zero rather than the 7% increase the company reported for the quarter.**

- We estimate that a decline in provision expense as a percentage of sales adjusted for the non-GAAP add-back of reversals of pre-pandemic receivables added about 0.6 cps to EPS in the quarter. The bad debt allowance is down to 1.4% of gross receivables. This artificial tailwind should finally disappear going forward, especially given the company noted on the call that it will be paying attention to its receivables balances in the near future for signs of stress from a slowing economy.

- As is typical for SYY, the quarter featured 2.3 cps in "Restructuring and Transformational Project Costs" added back to non-GAAP profits.

- The company reversed $2.6 million of its inventory return allowance related to its Covid PPE equipment which it removed from its non-GAAP profit figures. Remember that it took charges of $44 million and $30 million in the 7/22 and 3/22 quarters, respectively to write down the value of the inventory.

- Food price inflation continues to help drive the top line, adding 10% to total growth in the quarter. The company stood by its outlook to grow sales in FY 2023 by at least 10% with inflation falling to "low single digits" by the fourth quarter. As noted above, case volume growth without acquisitions looks weak which could make hitting that target difficult should food price inflation wane.

On Deck Risks

Cintas Corporation (CTAS)

Cintas (CTAS) is favored by many investors for its predictable revenue stream courtesy of its largely unchallenged leading position in the outsourced employee uniform business. However, some recent unusual reserve activity, premium valuation, and all-time high stock price warrant caution in upcoming quarters.

CTAS reported non-GAAP earnings of $3.39 for its first fiscal quarter ended 8/22 which was 25 cps ahead of target and sales came in about $80 million above the consensus estimate. The company raised the midpoint of its EPS guidance for the year ended 5/23 by 28 cps and its sales guidance midpoint by $235 million, both more than their respective first-quarter beats. We note that stock compensation fell by almost 8 cps. We saw two other items that could have provided material benefits to earnings in the quarter:

- We noted in a review of the 5/21 quarter that the company increased its reserve for obsolete inventory by $44 million due to excess personal protection equipment (PPE) after the initial wave of Covid. However, this reserve remained elevated for the last four quarters before falling by $11.2 million sequentially in the most recent 8/22 period. This alone could have added about 9 cps to earnings. However, even after that decline, the reserve percentage of almost 16% remains well above its pre-pandemic norm of 9%. We estimate this could be another approximate 30 cps of non-operational benefit that could benefit future earnings growth.

- In addition, we believe a lower-than-forecast tax rate could have accounted for 4-8 cps of the reported earnings beat.

Mondelez International, Inc. (MDLZ)

MDLZ reported adjusted EPS of $0.74 in 3Q22, which beat estimates by 5 cents. We did not see this as a clean beat. We are putting this in the On-Deck category because MDLZ's raised guidance looks very easy to beat for 4Q. MDLZ boosted organic revenue growth to 10%+ for the year from 8%. It would need $2.8 billion in organic growth to achieve that target and is already at $2.34 billion through 3Qs. It only needs $455 million more in organic growth in 4Q22 which is 5.9% y/y growth and that compares to the last easy comp on pricing of only 2.6%. For 3Q results:

- The company guided to low-mid 20% range on tax rate and came in at 18.8% down 450bp. This added 3.7 cents to EPS.

- MDLZ took the largest price hike in Latin America in years of 25.8%, FX was only a 10% hit against that. So, net pricing was up 1580bp- if that was 500bp lower, it would reduce EPS by 2.2 cents.

- However, many commodity prices are falling now and large retailers are pushing for price cuts. North America had a 12.6% price hike, if that was only 11.6% - it costs MDLZ 1.2 cents. Europe took 9.8% in pricing, at 8.8% that's 1.6 cents in EPS lost.

- We are concerned that despite the huge price hikes, gross margin is down. MDLZ is leveraging SG&A, but is not guiding to higher marketing and promotional spending. Marketing raises SG&A which is already rising in dollar terms and promotional spending lowers sales which may see more pressure if pricing gains aren't as pronounced.

- We would be concerned about the company meeting the 1Q23 outlook, but MDLZ appears to have an easy bar to clear for 4Q22 results.

Teva Pharmaceuticals (TEVA)

We see the same problems with TEVA and view it as a trading stock between $7-$11 and there are many moves each year within that range. Earnings quality is very low in our view as it adds back many recurring costs – particularly litigation. For 3Q22, TEVA's adjusted EPS of $0.59 missed by 3 cents. We think that should stun investors as the tax rate came in at 9.1% vs. guidance of 13%-14% and added 3 cents that may not recur.

- TEVA also added back 17 cents in litigation costs, which is lower than 1Q and 2Q, but still is 29% of the EPS TEVA did report:

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Legal Cost	$195	$729	$1,124	$604	$3	$6	$104	$50	$21
NonGAAP EPS	$0.59	$0.68	$0.55	$0.77	$0.59	$0.59	$0.63	$0.68	$0.58
Beat/Miss	-$0.03	$0.12	$0.00	$0.04	-$0.06				
Legal EPS	$0.17	$0.54	$0.83	$0.45	$0.00				

- TEVA also saw EPS of 19 cents from drawing down sales allowances again. This trend was interrupted in 2Q. We think this is a source of income likely to become smaller and a headwind more often:

	3Q22	2Q22	1Q22	2021	2020	2019	2018
New Sales Allowance	$3,147	$3,382	$3,088	$13,426	$14,415	$16,767	$18,899
Allowance Used	$3,379	$3,309	$3,522	$14,009	$15,750	$17,319	$20,069
Net change	($232)	$73	($434)	($583)	($1,335)	($552)	($1,170)
EPS Impact	$0.19	($0.06)	$0.32				

- TEVA is also supposed to be paying down debt and moving enterprise value from debt to the stock price. The goal for years has been to get to under 3x EBITDA. However, TEVA is also growing its Legal Accrual and it's over $4 billion now. That makes net debt to EBITDA 4.9x.

	3Q22	2Q22	1Q22	4Q21
Legal Accrual	$4,077	$3,928	$3,762	$2,710
Net Debt	$19,041	$20,024	$20,742	$20,878
Total	$23,118	$23,952	$24,504	$23,588
EBITDA	$1,089	$1,134	$1,135	$1,373
Free Cash Flow	$795	$301	$117	$716

Top Values

Air Lease Corporation (AL)

Date Added	9/27/2022
Market Cap	$4.2 B
PE (fwd)	Na
Short %	2.5%
Current EQ Rating	4+ (Acceptable)

Air Lease's non-GAAP EPS of $1.32 in 3Q22 beat forecasts by 5 cents. That is with several headwinds, so we consider the beat solid:

- AL has a few lease customers where it recognizes lease revenue only when the cash is received. In 3Q, it had $6.2 million that was not recognized as it did not arrive by September 30. That is 5.6 cents of lost non-GAAP EPS. AL noted that nearly all of that was paid in the early days of October and will count toward 4Q.

- AL guided to aircraft sales of $750 million for 2H22 after 2Q22 results. In 3Q, it saw only one sale completed and this source of revenue came in at $19.9 million. It is now guiding to $150 million for 2022, which implies about $90 million for 4Q and $700 million for 1H23. It did note that it has a strong pipeline for these sales and is seeing solid demand and prices for potential sales. This has been another timing issue that hurt 3Q, but appears ready to start contributing to EPS again going forward.

- Delivery of 14 new aircraft came in at $0.9 billion for 3Q and much of it occurred later in the quarter. That means lease revenue did not reflect a full quarter of these new deals. That should add to 4Q revenue. Also, AL is forecasting that 4Q deliveries should be about $1.2 billion.

- We still see book value at $59/share vs. the share price of $39. We also see reasons to point to book value being lower than fair market value.

    - $5-$6 of book value could return if the insurance claims over the Russian planes are resolved. AL did recover one 737-Max from Russia in recent weeks and that should add to book value in 4Q.

    - With the shortage of planes worldwide and continued delays in deliveries, the value of aircraft should be rising vs. the depreciated level it is carried on the books. AL has already commented that it is getting strong prices for used aircraft. The aircraft on the balance sheet amounts to $215 per share. If FMV is 1% higher – that could add $2 to book value. And the delays from Boeing and Airbus are expected to continue as more orders are placed amid air-traffic levels that are recovering rapidly to pre-Covid levels.

    - Aircraft that are being placed since interest rates have increased are getting higher lease rates due to interest rate escalators in place. Plus, high demand for planes in a market without supply is also raising lease rates. Those should be a long-term tailwind for income and for growing book value.

    - At the same time, AL has surplus capital and its debt is fixed-rate at 2.85%. Its spread should be increasing going forward.

- Deferred rent from Covid shutdowns continues to decline. It was $163.1 million at the end of 3Q vs. $182.1 million at the end of 2Q.

- We would still watch the strong US Dollar as an issue given that many of its foreign customers are paid in local currency and pay for their fuel and leases with dollars.

Ares Capital (ARCC)

Date Added	12/2/2022
Market Cap	$10.2 B
PE (fwd)	10.0
Short %	-
Current EQ Rating	4+ (Acceptable)

ARCC is interesting to us because it benefits from rising interest rates and its structure requires it to pay out the bulk of earnings as dividends, so the dividend level is increasing and it is already yielding over 10%.

- 3Q22 core earnings were $0.50 beating forecasts by 1 cent. Had the interest rate increases been in place the entire quarter, core earnings would have been $0.54.

- ARCC also noted that another 100bp of interest rate increases would add 7 cents per quarter to core earnings. The bulk of its loans are floating rate. Thus, a case can be made that there is reasonable line-of-sight to quarterly EPS topping 60 cents.

- It has already boosted the dividend from $0.43 to $0.48 per quarter and is paying a $0.03 special dividend this year to return some past earnings that have yet to be paid out – called spillover income. There is still $1.36 of spillover income.

- ARCC has $4.1 billion of liquidity and only $750 million of debt due before the spring of 2024. However, Debt-to-Equity finished the quarter at 1.25x which is at the high end of the range management wants to be. That would make it difficult to put new money to work other than redeploying payments received. ARCC has three potential sources of additional capital that could make this ratio lower:

    - Repayments of existing loans (or selling some positions) produce cash and reduce the net-debt figure. Here are the recent rates for repayments – about $1-$2 billion per quarter:

	3Q22	2Q22	1Q22	4Q21	3Q21
New Commitments	$2,242	$3,109	$2,001	$5,866	$3,110
Exits of Existing	$1,996	$1,085	$2,551	$3,869	$2,263

    - In recent quarters, not only did interest rates rise, but credit spreads widened and that led to unrealized losses on the portfolio as ARCC marketed investments to market of 36 cents per share in 3Q22 and 29 cents in 2Q22. Spreads normalizing could see these unrealized losses reverse and bolster equity or having the loans repay at par would do the same.

    - They raised an additional $180 million in 4Q, which boosts equity too.

- One risk is loans becoming non-performing – recent results are not seeing this. Part of this is the loan to value on these companies is about 50% of fair value, so the equity investors have strong incentives to support these companies in the event of a problem. Plus, the average company ARCC is financing just reported 13% y/y EBITDA growth, so their Debt-to-EBITDA ratio is falling. With banks pulling back from the market, ARCC is getting tighter documentation and covenants on loans now too.

- A second risk is duration – many of these companies repay their debt by going public, being acquired, or refinancing. With interest rates rising – ARCC is not in a bad place to have their rising cash flows have extended lives in our view. However, it does potentially limit the amount of cash returning for new deals.

AT&T, Inc. (T)

Date Added	3/12/2021
Market Cap	$137.4 B
PE (fwd)	7.4
Short %	1.3%
Current EQ Rating	4+ (Acceptable)

AT&T's non-GAAP EPS of $0.68 beat forecasts in 3Q22 by 6 cents. The company is expecting to hit the high end of guidance for wireless of 4.5%-5.0% growth. The company also held its forecast for $14 billion in free cash flow. The beat looks solid to us:

- There was an unexpected bump from selling $100 million in intellectual property at the Business Wireless unit vs. $20 million the year before – that translates to 0.8 cents.

- While the bad debt reserve was down slightly from 2Q's $655 million to $646 million for 3Q22, bad debt expense was still a headwind, rising $202 million y/y that hurt EPS by 2 cents.

- AT&T expects to reach a run-rate of $4 billion in lower costs by the end of 2022 of the $6 billion goal. Much of this is expected to come from retiring copper lines and moving people to fiber. Also, retiring and taking down 3G infrastructure was a large expense in 4Q21 that won't recur in 4Q22. The additional $2 billion of cost savings they are targeting would ultimately be worth 5 cents per quarter in EPS.

- ARPU for both wireless and fiber is rising. This is a combination of roaming fees returning, promotional pricing rolling off, and better deals leading customers to transfer to higher-priced unlimited plans.

ARPU	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Post-Paid Phones	$55.67	$54.81	$54.00	$54.06	$54.37	$54.24
Fiber Broadband	$58.63	$57.64	$56.66	$55.96	$55.16	$54.76

  - Also, remember that fiber broadband sees greater profitability from incremental customer additions as the infrastructure investment is minimal for later adds and it spreads fixed costs over more revenue.

- Bad debt reserves declined slightly from 2Q22's $655 million to $646 million in 3Q22. However, the expense figure rose sequentially by $43 million and y/y by $202 million in

3Q. The $202 million costs AT&T 2 cents in EPS. More importantly, AT&T noted that after rising two days in 2Q22, receivables DSOs did not rise in 3Q22. After the jump in DSOs and bad debt reserves in 2Q, AT&T noted that it is nearing normal pre-Covid levels too. This did not make cash flow worse. AT&T is sticking to $14 billion in free cash flow after reporting a $1 billion headwind in 2Q due to rising receivables. If the bulk of the bad debt expense was booked early in the 3Q, 4Q22 sets up with an easier comp as bad debt expense in 4Q21 was $383 million vs. $251 in 3Q21.

- Business Wireline improved, in 3Q, but was helped by a $100 million sale of Intellectual Property. AT&T gave little information on this other than to say these happen opportunistically and are lumpy. This helped both revenue and EBITDA:

Business Wireline	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Revenue	$5,668	$5,595	$5,460	$5,901	$5,938	$6,052
EBITDA	$2,224	$2,023	$2,158	$2,193	$2,306	$2,362

The net gain from the sale was an $80 million y/y increase in sales and EBITDA, which amounts to just under 1 cent in EPS. The $80 million was all the revenue increase, but with EBITDA up $201 million, some of the cost-cutting is looking effective. AT&T did not change the forecast from continued decline, but it does have some easier comps coming up after 4Q.

Costco Wholesale Corporation (COST)

Date Added	12/2/2022
Market Cap	$238.7 B
PE (fwd)	34.4
Short %	1.05%
Current EQ Rating	5+ (Strong)

Costco does not have much in the way of earnings quality issues that concern us. There are a few moving parts such as LIFO charges and gasoline prices impacting sales and margins to be aware of, but in the big picture, COST is about as clean as it gets. The company does not use non-GAAP EPS. Thus, some of the accounting procedures can be positive or negative in any given quarter and COST is very upfront in pointing this out and quantifying it. For a company that just made $13.14 in EPS for fiscal 2022 (ending in August) and is expected to earn $14.59 for fiscal 2023, items that amount to a few pennies are not very concerning in our view.

- Balance Sheet positives – Cash of $11 billion exceeds total debt of $6.5 billion; intangible assets are only $993 million vs $20.6 billion in equity.

- Cash flow is seeing inflation-driven inventory investments in dollars rise faster than payables which is cutting into cash flow by $2.1 billion in fiscal 2022. COST still covers its dividend and capital spending easily.

- Inventory DSIs look in line with pre-Covid levels. There was concern that non-food inventories grew, but COST sees that more as an issue of having levels about 10% too low last year. Really, inflation and new stores are the bulk of inventory growth in dollar terms.

- Same-store sales comps are being driven by higher selling prices and higher traffic. With its focus on offering lower unit prices to customers than competitors, it is pulling in more members and existing members are renewing. We think this is where inflation is helping growth and earnings at Costco. It is picking up volume and members may continue to shop there even if inflation declines.

- Inflation is impacting cash flow because payables did not rise nearly as much as inventory in 2022. This cut free cash flow by $2.1 billion last year. We don't see this as a critical problem, COST has more than enough liquidity and it still covers its dividend easily.

- Membership fees are the big hidden asset here. Customers pay $60 to join the club and $120 to join the executive level where they can earn 2% reward coupons on some purchases that can be used at the store. With 119 million members, and growing, this

generated just under 2% of total revenues. However, at almost no cost, the $4.2 billion in member fees was 54% of its operating profit in 2022. COST has not raised the price here but has seen more members upgrade to the higher levels. If they boosted the price by $1-$5 per year it would add $0.20-$1.00 to EPS.

- Gasoline sales can skew some numbers in the income statement. The gross profit per gallon stays fairly constant and there is almost no SG&A expense. When the selling price falls, total sales decline, gross margin rises, but SG&A as a percentage of sales increases. When the price increases with inflation, the reverse happens. Higher volumes will drive sales and profits higher, but we do not see much impact on results from inflation or deflation of gas prices.

- Merchandise margins are under pressure from inflation. Management is seeing some signs that relief is coming in a few areas. We believe with a fast inventory turnover, COST likely won't get killed if inflation cools and leads to lower selling prices. However, its operating model requires it to lower prices faster than competitors. The problem is a low retail profit margin of about 160bp. On recent numbers, we estimate that a 25bp drop in selling prices could hit margins by 19bp and EPS by 81 cents.

- The LIFO charge was something COST hadn't seen for several years as the value of its inventory under LIFO or FIFO was equal. In fiscal 2022, inflation led to a $438 million charge or 74 cents of EPS to move inventory to a LIFO fair market valuation. If inflation slows, the size of this charge should decline. That could offset impacts of having selling prices decline faster than costs. Since COST doesn't adjust out the LIFO charge from reported earnings, it is tempering inflation positives now but should add to y/y earnings changes if inflation cools.

- Overhead costs are rising with inflation. Primarily this applies to wages. From March 2021-July 2022, COST has given five pay raises to employees. Also, 28% of sales come from California which is a high-cost area to operate in from a labor standpoint. This looks like permanent increases in the cost structure. If inflation cools, the selling prices for much of its products should drop, but we doubt wages will.

LyondellBasell Industries N.V. (LYB)

Date Added	7/14/2021
Market Cap	$27.7 B
PE (fwd)	6.8
Short %	2.6$
Current EQ Rating	5+ (Strong)

LYB's 3Q22 and its 4Q22 are showing the effects of high energy prices in Europe and Chinese lockdowns. For European operations that makes the cost structure either too high and/or the supply of raw materials and power limited and several plants have been idled. The positive is some were scheduled for maintenance already and that will be completed during this time, but restarting is expected in 1Q23 rather than 4Q22. For China, it imports a great deal of its chemical feedstocks and demand is down with lockdowns. For a market operating in a shortage for almost two years, we do not expect a couple of quarters of supply/demand disruptions to derail the long-term chemical story based on lower-priced feedstocks in the US giving LYB a decided operating edge over many foreign competitors.

- We still see very few earnings quality issues for LYB. It still plans to close its refinery and has some restructuring charges related to that in earnings.

- The lower pricing of feedstocks in some cases and chemical demand have resulted in cash flow being freed up from working capital. In 3Q22, working capital produced $227 million of cash largely from lower receivables. That was a reversal from consuming $494 million in the first half of 2022.

- DSIs for inventory finished at 43 days, up from 38-41 days in recent quarters. Given the rapid changes both up and down in costs through the quarter, that probably played a role here. We have noted that LYB normally carries 55 days of inventory and expect that to rise in 2023. LYB may need another $1 billion-plus in inventory in 2023, but payables were also reduced by $550 million in 3Q, so payable growth may offset much of any needed inventory growth cash drain.

- Feedstocks for Europe are skewed with the various issues regarding lower volumes of Russian gas and higher oil prices. Europe never had the full impact of lower feedstock costs from US fracking of natural gas. LYB has the flexibility to change feedstocks in many cases. However, Europe uses more naptha refined from oil in the $80-$90 level and the US can still use Natural Gas Liquids like ethane, butane, propane, and

intermediate chemicals from those commodities produced off US natural gas that is still about $6 down from $9. When oil is more than 8.5x gas – US natural gas has a decided cost advantage. Thus, LYB is going to run less capacity in Europe in the near future.

- LYB announced it is beginning a number of small changes designed to pull $750 million out of operating costs out of the business model over 3-years. The bulk of these are expected to cost little in cash payments or capital spending. LYB has a good track record of achieving lower costs over time and after a few expansions of capacity, acquisitions, JVs and plans to close the refinery – there likely are new opportunities to reduce spending. This along with the new PO/TBA plant should boost mid-cycle EBITDA over $9 billion at LYB. That's 4x mid-cycle EBITDA for the valuation here. Plus LYB continues to retire shares and boost its dividend. After retiring debt to pay for recent acquisitions, debt stands at only 1.0-1.1x EBITDA. Much of the free cash flow is now available for shareholders. The dividend is only $1.5 billion per year with a yield of 5.6%.

National Instruments Corporation (NATI)

Date Added	3/12/2021
Market Cap	$5.4 B
PE (fwd)	21.6
Short %	2.6%
Current EQ Rating	5+ (Strong)

NATI's non-GAAP EPS of $0.53 met forecasts. Revenue beat slightly with 17% y/y growth, but much of this is overshadowed by NATI's 4Q guidance. NATI reported semiconductor order growth went flat in the last two weeks of 3Q and it is expecting that to continue in 4Q where it also has a tough comp due to large orders in 4Q21. We are not reducing the rating as we do not see the accounting getting worse and more importantly many more signs point to operating leverage being unleashed in the near future.

- Having backlog decline by $9 million in the 3Q, helped EPS by as much as 4 cents. Without this NATI would likely have missed forecasts.

- Cash flow continues to be impacted by rising inventories and rising prepaid expenses. Both have supply chain-related causes. YTD cash from operations is down $95 million y/y. Prepaid expenses are up $54 million on insurance premiums and higher freight costs and inventory is up $85 million with higher costs to find and deliver it.

- NATI sees supply chain issues starting to improve. This positive trend may continue if semiconductor demand growth stalls with economic slowdown. The important part for NATI is it supplies customers with testing equipment and R&D products, where spending is unlikely to decline. Its orders are still rising. The part of its business exposed more to semiconductor end-markets is its portfolio business. That is about 32% of sales, about half of that is economically sensitive, and NATI is not very exposed to consumer devices like cell phones, cameras, etc. It sells more to the production lines developing the new products.

- If supply chain constraints mitigate in 4Q22 and beyond, it should allow NATI to fulfill more of its $240 million in backlog – and those sales would help total growth and margin leverage. Management sees this happening – they are uncertain if it happens in a bigger way in 4Q or early 2023.

- Supply chain constraints being resolved should reduce inventory costs and prepaid expenses as NATI has been paying 500-600bp of its margin for brokers to locate critical

parts and expedited shipping. That should allow cash flow to improve with inventory and prepaid expenses declining.

- Margin forecasts may be too low, but the timing is unknown and also tied to supply chain issues resolving further. NATI is on pace to reach its goal of 100bp of margin gains in 2022 and has a target of an additional 300bp of improvement in 2023. We see much cushion in these forecasts if the supply chain continues to improve.

- Reducing brokerage fees and accelerated shipping are 500-600bp of margin to play with already. Pricing that NATI has taken in February and August has not fully shown up in recent results but is already adding about 200bp of margin and offsetting FX.

- Price increases in February and August are helping revenue growth and margins. On the call, NATI expects this to hold as it is selling systems more than individual parts and is build into the system price to customers. They are already getting some margin leverage in this area too ahead of FX headwinds:

Pricing	3Q22	2Q22	1Q22
Rev Growth from Price	9.0%	6.0%	4.0%
FX hit to Revenue	-5.0%	-2.0%	-1.0%
Margin gain	2.4%	2.0%	1.0%

- We noted in the past that NATI did one of the quickest and cleanest restructurings we had seen in late 2020 and it has held headcount down and moved more operating costs to align with revenues rather than being fixed. Thus, it is already picking up margin leverage on operating costs while still boosting total dollars invested.

- The backlog also looks solid and is a cushion against any order weakness. NATI confirmed again it does not see double ordering and less than 1% of its backlog has canceled over the last 18 months of it building up.

Starwood Property Trust, Inc. (STWD)

Date Added	2/8/2022
Market Cap	$6.6 B
PE (fwd)	9.4
Short %	2.0%
Current EQ Rating	5+ (Strong)

STWD's 3Q22 posted $0.51 in Distributable Earnings (which eliminates non-realized gains/losses and mark-to-market values, and depreciation). This missed forecasts by 1 cent, which did not concern us. The overriding reason for the miss in our view is STWD built more liquidity and did not put as much capital to work later in the quarter. STWD likely ended the quarter with about $700 million in liquidity or about $400 million more than usual. At an 8% return for half a quarter that is 1-cent in Distributable Earnings. We also saw that:

- STWD has another headwind of $348 million in equity tied up in work-out loans not earning a return that can be booked at this time – that cost 2.2 cents.
- STWD booked a $5 million loss on a mortgage originator that it acquired years ago and is restructuring the operation – that cost it 1.6 cents.
- Offsetting that – STWD did book a $12 million gain on an asset sale that added 3.8 cents.
- STWD noted on the call that is being defensive at the moment and hoarding liquidity waiting for great bargains. They do not have to refinance debt, they do not have to sell assets in this market, it has non mark-to-market financing on 89% of its on and off-balance sheet debt, and it has 100% collection on loans. It has $1.3 billion in liquidity, $8.5 billion in undrawn credit lines, and $3.9 billion in unencumbered assets.
- Its largest concern is that credit spreads have widened and that can impact its book value via non-realized losses. They are hedged against base rates and FX but they cannot easily hedge against mortgage loans being priced at 300bp over treasury instead of 50-100bp. It noted that its Residental lending unit that buys non-Agency loans has seen credit spreads widen as the FED stopped buying mortgages and other buyers have pulled back too. Thus, STWD is not adding to these positions at the moment because the spreads have widened and that hurt the value of the current portfolio with a $92 million unrealized mark-to-market hit for GAAP purposes. They see great value here and can wait out the wider spreads, but want to see more of an inflection point before rising marks against book value. They are likely to redeploy payments that are received, but will continue to hold their $1.3 billion in liquidity for now.

- There are still several earnings drivers here, beyond deploying more capital:
    - STWD issued $3 billion in CLOs (Collateralized Loan Obligations) in prior years that moved those assets and debt off-balance sheet to remove the mark-to-market issues. It has the ability to reload those CLOs with new loans that repay. Thus, in this market it will be able to put higher interest rate loans into the structure and the funding costs remain 150bp below the market. Thus, STWD will see a widening cash spread there.
    - It has interest rate increases coming still. In 3Q, it saw 100% of the rates on its loans exceed the interest rate floors it has in place and had higher income as a result. Going forward, 100bp of interest rate increases adds 3.3 cents to Distributable Earnings per quarter. New loans are being set up with higher floors now that would preserve higher income levels should rates decline again.
    - Rent increases should continue on its property. It had a 10.6% rent increase begin on the Florida housing properties on October 1. The rising cash flow stream is also financed on fixed-cost debt, so that cash spread is widening. It should also continue to boost property values that would drive GAAP earnings and create the potential for higher dividends.
    - LNR, the special servicing unit, is seeing business grow and it is being named as a servicer for more deals. This is lumpy income, but it is now a special servicer on $107 billion in deals up from $95 billion at the start of the year, and is actively working on $4.1 billion in loans and $1.8 billion in real estate in default. It gets paid at the end of work-outs.

Texas Instruments Incorporated (TXN)

Date Added	3/12/2022
Market Cap	$163.8 B
PE (fwd)	18.7
Short %	2.2%
Current EQ Rating	5+ (Strong)

TXN's adjusted EPS of $2.56 beat by 14 cents and came in 5 cents over the high-end of guidance. The accounting remains very clean and high quality. TXN pointed to slowing sales for 4Q22 with revenue of $4.4-$4.8 billion and EPS of $1.83-$2.11. It did see some cancellations start from customers in 3Q too. After growing sales in 3Q in 4 of 5 end markets, TXN sees 4Q showing growth only in autos.

- The beat looks solid. The 7 cents of start-up costs should start moving to Cost of Goods in late 4Q. That will stop this cost from being reported as its own line item as 2023 starts.

- Pension costs rose by $10 million in the quarter and stock compensation rose by $18 million. Combined those were headwinds of 2.6 cents.

- Cash flow was flat at $1.976 billion vs. $1.942 billion y/y despite $300 million of higher capital spending. There was help from receivables declining $150 million while inventory rose $205 million.

- DSO's are coming back down again which is a positive. Remember that 2Q was back-end loaded due to China orders being fulfilled late in the period. DSOs for TXN are nearly always 32-33 days and hit 38 days in 2Q22. It declined back to 36 days in 3Q.

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Accts Rec.	$2,040	$2,190	$1,795	$1,701	$1,653	$1,591	$1,584	$1,414
DSO	36	38	33	32	33	32	33	32

- Inventory is still below TXN's target and it is likely to keep producing to get back to levels where it can avoid out-of-stocks. That runs fixed costs over more output too, but we expect inventory to consume cash flow going forward at least $800 million more.

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

- Expect depreciation to become more of a headwind as the first new plant starts up in late 4Q/early 1Q. Deprecation in 3Q22 was $249 million vs. guidance for the year of $1 billion.

United Rentals, Inc. (URI)

Date Added	12/13/2021
Market Cap	$24.5 B
PE (fwd)	11.0
Short %	4.5%
Current EQ Rating	4+ (Acceptable)

We recommend readers refer back to our original report for our complete thoughts on URI. We think URI's accounting quality is very strong and the company is not as cyclical as many think. Half the business comes from non-cyclical construction such as transportation, large infrastructure projects, manufacturing plants, and energy production. Another 46% is commercial construction (which is cyclical) and remodeling. It is still beating forecasts and boosting guidance: $9.27 in 3Q21 beat by 21 cents, and it raised EBITDA guidance and the amount of new equipment it will buy in 2022 after 3Q results. At 6x EBITDA < 11x EPS, we think it's a cheap stock for the amount of growth it produces.

The fast amortization periods mean that even though URI adds back amortization to non-GAAP results, the spread between GAAP and non-GAAP is shrinking:

EPS Impacts	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
GAAP EPS	$8.66	$6.90	$5.05	$6.61	$5.63	$4.02	$2.80
Merger costs	$0.00	$0.00	$0.00	$0.00	$0.00	$0.03	$0.00
Amortiz Intang	$0.44	$0.45	$0.52	$0.47	$0.53	$0.48	$0.50
Acq Dep Life chg	$0.12	$0.26	$0.10	$0.13	$0.01	$0.01	$0.02
FMV of Acq Equip.	$0.05	$0.05	$0.06	$0.10	$0.08	$0.08	$0.12
Non-GAAP EPS	$9.27	$7.86	$5.73	$7.39	$6.58	$4.66	$3.45

Our only knock is using EBITDA as a metric to compare to debt. URI's business model relies on buying new equipment and selling old equipment. The net capital spending is not a discretionary item which EBITDA conveys. Many would compare net debt of $9.9 billion to forecast EBITDA of $5.5-$5.6 billion and say, debt to EBITDA is 1.8x.

URI just raised guidance for capital spending further following 3Q results from a mid-point forecast of $3.0 billion to $3.35 billion. That will also raise spending net of equipment sales by $350 million too. That makes a net EBITDA figure decline slightly and makes the more realistic ratio for debt 3.1x:

	2022e	2021	2020	2019	2018
Rental Equip Bought	$3,350	$2,998	$961	$2,132	$2,106
Rental Equip Sold	$1,000	$968	$858	$831	$664
Net Spend	-$2,350	-$2,030	-$103	-$1,301	-$1,442
EBITDA	$5,550	$4,414	$3,932	$4,355	$3,863
EBITDA - CapX	$3,200	$2,384	$3,829	$3,054	$2,421
L-T Debt	$9,910	$9,685	$9,682	$11,428	$11,747
Debt/EBITDA	1.8	2.2	2.5	2.6	3.0
Debt/net EBITDA	3.1	4.1	2.5	3.7	4.9

On Deck Values

Air Products and Chemicals, Inc. (APD)

We are moving this to On-Deck because of valuation. The accounting quality is solid in our view with a few cents of items in EPS at times that are minor compared to EPS of $11. We like the long-term growth story and EPS should continue to rise. But with guidance at $11.50 and the stock at $310, a forward P/E of 27 is pricey. The growth rate is solid and the foundation is there for that to continue. The CAGR is 11%. So call the PEG 2.5x which is still pricey in our view. However, compared to a tech name, this makes a great deal of sense. It has high-quality earnings, less macro risk as much of the commodity issues can be passed through, it produces cash flow, it has a 10% growing dividend, and has enough growth projects on the books to keep producing higher results.

Thoughts on the last quarter:

APD's non-GAAP EPS of $2.89 for fiscal 4Q22 beat forecasts by 13 cents. There were two adjustments to non-GAAP (which has been a rarity for APD). One was an impairment of $14.8 million or 5 cents for two Asian equity-method investments. The other was 27 cents related to the divestiture of its Russian operations. Both do appear to be one-time in nature that should not recur, so APD still gets high marks so far on GAAP vs. non-GAAP earnings.

APD has stopped construction on a project in Ukraine and there is $45 million invested there so far. That may become another write-down in the future. Also, APD announced it will start reporting adjusted EPS without non-service components of Pension Benefit/Cost. This is included in Other Non-Operating Income (Expense) below the operating income line. In 2021, APD realized higher pension income due to higher assets used for expected rate of return and lower interest cost. In 2022, this reversed as it cut the expected rate of return and it declined by $38.3 million or 14 cents of annual EPS.

- The long-term growth story appears intact with additional projects being planned. APD continues to point toward managing its debt to stay under 3x EBITDA through the construction process. We will point out that we would expect to see interest expense rising here with rates increasing and APD borrowing more money. However, it does capitalize interest expense on projects under construction. That is a normal policy, but it can create some lumpiness in APD's reported interest expense. For example, in 2022,

Interest expense was $169.0 million vs. $170.1 million in 2021. However, net interest expense declined by $13.8 million not $1.1 million because capitalized interest jumped by $12.7 million. This added 5 cents to 2022 EPS.

- The quirky part of APD's accounting involves its on-site plants. These are set up with long-term contracts whereby APD earns a set return per unit and raw material and power costs are passed through to the customer at cost. When the raw materials and power expense rises – it boosts both sales and cost of production while income remains the same other than volume changes. Thus, inflation causes margins to decline, and deflation causes margins to rise. This was on full display this year as APD experienced heavy inflation, especially in Europe where power costs rose five-fold. So, EBITDA margins which peaked at 42.7% with Covid deflation, are now 32.1% in 4Q22, but income is up.

- The merchant plant operations have commodity risk. APD passes through the costs on a lagging basis. The higher inflation it has seen bodes well for more price increases. The Russian/Ukraine war is creating many of the issues for European electricity and oil/gas supplies. Resolving that in some manner could actually allow APD to see costs decline and bolster earnings. Regardless of the war, APD has successfully navigated inflationary issues and grown earnings.

Ball Corporation (BALL)

There are reasons to not like BALL. We do not like the unusual fluctuations in BALL's depreciation nor the recent accounting change increasing estimated useful lives. We have been negative on its use of receivables factoring and stretching payables to boost cash flow. Management's sudden change of tone last quarter from implying it can't expand capacity fast enough to meet demand to suddenly closing plants in the US further erodes their credibility in our minds. All these factors are why we still rate its earnings quality as a 3- (Minor Concern). Still, this is a real company serving a market that should see above-trend growth from the switch to aluminum packaging once volume at beverage companies normalizes. We maintain it as an On Deck value as we believe the market has gone too far in punishing recent underperformance and it is worth exploring as a potential value at these levels.

BALL reported non-GAAP EPS of $0.75 which missed the consensus estimates by 5 cps. We believe the miss was worse than it appears at first glance due to an unexpected benefit from the company increasing its estimated useful lives of buildings and test equipment (discussed below).

- We highlighted in our review of last quarter how the company's depreciation expense showed an unusual sequential decline of $11 million despite an increase in average gross PPE in service and one more day in the quarter. We also showed that depreciation as a percentage of gross PPE in service has been falling for a couple of years. Ironically, the company disclosed that effective July 1, it increased the estimated useful lives of certain buildings and test equipment which reduced depreciation by 6 cps below what it would have been in the quarter under the old method. This makes 5 cps earnings miss even worse.

- While the change in depreciable lives was noted in the press release and the 10-Q, we found it interesting that it was not mentioned at all during the call. The 3Q22 benefit of changing methods was $24 million pretax while the full-year 2022 benefit is expected to be $48 million. Therefore, the first six months of 2023 should see another $48 million in reduced cost in the first two quarters of the year, after which the change will have lapped. However, we were struck by the fact that the company said nothing about the impact of lower depreciation during the call while discussing its cost outlook and none of the participating analysts asked about it. The company highlighted that it would cut $150 million from its cost structure in 2023 but it seems like almost a third of that is the result of an accounting change.

- In addition, the stock price decline resulted in an additional 3 million anti-dilutive options being excluded from the diluted share count which boosted EPS by 1.2 cps.

- The company admitted that cash flow will remain depressed in 2022 but expects 2023 to improve due to $500 million in lower capex, lower incentive comp, and no pension contributions. Working capital has also been a drain as the company built up inventories at higher prices coming out of 2021. The working capital situation should improve in 2023 as the company works down inventories and metals prices ease.

- BALL repurchased 4.3 million shares in the second quarter under its ASR. The reduction in share count added about 2 cps to EPS growth in the quarter. This tailwind will last the next two quarters. With net debt/EBITDA at 3.9, we would expect the company to be more limited in what it can spend on share count reduction.

- While we have our misgivings about BALL's accounting over items such as the increased depreciable lives estimate, we believe the company should be in decent shape in 2023. It is in a position to recapture costs as its pass-through provisions in many of its contracts continue to kick in. We don't see that beverage companies can continue to let volumes erode due to price increases which could help volume growth in 2023. Also, the company makes a compelling case that should we enter a recession, demand will shift to at-home consumption which benefits the aluminum can in the packing mix.

DocuSign, Inc. (DOCU)

DOCU reports next week so we will update in early December. Below is our note from the last Focus List:

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)

The market follows new construction when it reads OTIS news. That is about 30% of sales and has seen weakness for several quarters from China. Management is starting to see new construction improve and it has easy comps coming. It also points out that it does not have inventory or labor problems dealing with new construction installs – one of the wildcards has been lack of construction crews for the rest of the building which means the project gets delayed and OTIS has to wait until they can make the installation. To us, the OTIS story is about the other 70% of business related to service/maintenance of existing systems and modernization of older installed systems. This business has 3x the profit margin of new construction as well as being more than twice the sales figure. Plus, much of this business cannot be delayed and that includes modernization efforts as buildings want to remain competitive for tenant demand. OTIS has a long-term process of adding more digital monitoring of existing systems which enables it to diagnose problems remotely and can either reset systems remotely and avoid an on-site visit, or they can make the repair with only one visit vs. two when they had to diagnose the problem on-site. This is helping it improve margins 30-50bp annually with minimal cash costs. It has been also seeing a steady reduction in debt and share count to further add to growth.

Adjusted EPS at OTIS was $0.80 in 3Q22, which beat by 2 cents. We would not consider it a quality beat as:

- Bad Debt expense was $0 in 3Q, vs. $12 million the year before. That was worth 2 cents in adjusted EPS. Bad debt reserves are down $10 million since 2Q.

- Stock compensation was down $5 million y/y – that added 0.9 cents.

- Warranties beyond the normal service and parts policies is a small account that has been falling for some time. It had only $1 million of expense in both 3Q22 and 3Q21, but the balance is down from $20 million to $13 million YTD.

- Offsetting this was a higher tax rate – which OTIS guided to. It is still guiding to a 26.5%-26.7% tax rate, but in 2Q22 it was only 22.4% and helped OTIS beat forecasts. It expected 3Q to offset that and it came in at 28.2%.

OTIS cut guidance again. This has been a constant for 2022 earnings since the 4Q21 release. This has been a combination of China lockdowns, removing Russia, FX, inflation, and a lack of

labor for other construction firms meaning it has taken longer for projects to reach the stage when OTIS can do its installations.

- Receivables are up due to more billing coming later in the quarter as orders built. The peak was 92 days during Covid, OTIS is at 85 days now up from 83 in 2Q22. Turning the tide of orders is likely a larger positive than 2 days of DSO.

- Inventory is up with inflation and efforts to support order flow.

- Payables jumped as OTIS prepaid suppliers to lock in deals. This may still represent some cash outflow going forward.

- Contract assets/liabilities are the result of progress payments made during projects that may not fully match with revenue recognition. The drop in new orders in China skewed that in 2Q22. Also, with fewer new orders, there are more contracts near the end stage and these accounts meet at $0. If orders are picking up, this could return as a source of cash.

The maintenance/repair/modernization story for OTIS appears to be intact. The headlines are often on new-equipment orders. However, the M/R/M market has larger sales, about triple the profit margin, and it isn't something that can be postponed. Customers who postpone modernization, often have more service calls. The OTIS story is built on this area of the company reducing costs with more digital fixing of systems without on-site visits. They aim to reach 30-50bp of margin improvement annually, and that is still happening. The modernization business is also accelerating of late:

Maint/Repair/Mod.	3Q22	2Q22	1Q22	4Q21
Organic Growth	6.2%	5.2%	5.8%	4.0%
Maint/Repair	5.4%	4.9%	3.0%	4.3%
Modernization	10.3%	6.4%	-5.9%	2.2%
Adj. Op. Margin	23.9%	23.1%	22.9%	23.0%
Margin gain y/y	50bp	50bp	30bp	50bp

The goal to retire debt and shares is also continuing. The higher cash consumption of working capital lowered the cash balance so net debt looks slightly higher, but it's still only 2.3x adjusted EBITDA. Total debt is still coming down:

	3Q22	2Q22	1Q22	4Q21
Gross Debt	$6,562	$6,683	$6,745	$7,273
Net Debt	$5,528	$5,465	$5,510	$5,708
Shares	421.2	424.2	427.7	429.1

The Scotts Miracle-Gro Company (SMG)

There is admittedly a great deal of risk that comes with SMG and the bull case revolves around next year's spring selling season. Quite simply, if homeowners show up in the spring to buy lawn care and gardening supplies then SMG should be fine. Still, there is some question as to how many new Covid gardeners will stick around and how elastic demand will be at higher prices.

On a positive note, management adamantly declared it has no plans to reduce its dividend. It also declared it did not see going to the equity market as necessary although disappointing sales next spring and summer could force the company into desperate measures to stay in compliance with credit agreements. It has renegotiated its covenants to allow Debt-to-EBITDA to climb as high as 6.5x. Through cost-cutting and working down inventories it hopes to have its leverage ratio back in the 4s by next year. Still, profits are not likely to dazzle given that low production rates are expected to contribute to lower gross margins again in FY2023.

In our mind, these risks are offset by the company's compelling case that it posted positive revenue growth in past recessions as lawn care and gardening is a relatively cheap way for people to improve their homes compared to more expensive interior remodeling projects. Retailers are likely to help promote fertilizer and seed sales next spring as it is a key driver of foot traffic into their stores. Plus, the near-5% dividend yield, which looks safe for now, compensates investors while they wait for what will likely be a bumpy turnaround.

Warner Bros. Discovery, Inc. (WBD)

WBD's 3Q22 continued to have considerable noise from restructuring and building areas of the new company. Some of this was by design after 1Q and 2Q plans to halt several movies and programs that were in production and/or slated for release in 2022 as well as culling existing shows and remaking that content. Weaker advertising revenue was probably the biggest part of 3Q's news and that points to recession and some apples-to-oranges comps.

We're more focused on guidance for the next two years and in that area, we believe WBD is improving. Guidance for 2022 was $9.0-$9.5 billion in EBITDA and management is saying $9.2 billion coming out of 3Q, which would be continued sequential improvement for 4Q:

	4Q22e	**3Q22**	**2Q22**	**1Q22**
EBITDA	$2,629	$2,424	$1,766	$2,381

The $9.2 billion figure includes $150 million of accelerated amortization of HBO content in 3Q and weakness in the advertising market. It has now raised its cost synergy target from $3.0 billion to $3.5 billion by the end of 2024. That includes finishing 2022 with a run-rate of captured cost cutting of $750 million and $3 billion in free cash flow for 2022, which affirms prior guidance.

- Other plans are being accelerated such as the relaunch of the streaming business with Discovery and more content and features for release in the spring of 2023 vs. original plans for the summer of 2023. Also, plans were for streaming to break even on EBITDA in 2024 and post $1 billion in 2025. All the $3.5 billion in synergies pointed to by management and followed by the market are focused on cost-cutting. We don't think the market is giving the streaming forecast enough weight as the swing in EBITDA could be $3+ billion in just this unit.

- We still think this stock looks attractive and current guidance includes no revenue-driven income increases. Just adding the $3.5 billion in synergies to $9.2 billion in 2022's EBITDA would be $12.7 billion in EBITDA in about 2 years. With $48 billion of net debt assuming no pay-down, the stock is trading for 6x EBITDA. At 8x, the stock doubles to $22. At 10x, the stock is worth $33. WBD is forecasting debt reduction via free cash flow. There are 2.4 billion shares so every $2.4 billion they pay down adds $1 to the stock price.

- Advertising on a proforma basis for Networks was down 11% y/y. Management said that was the low range for its forecasts and that is hitting the stock price. Some of this was the

recession and that pressure continues for 4Q so far. Advertising is a $10-$11 billion figure per year, so this is a material item.

- Rebuilding the sales program hurt the process of selling advertising in 2Q and 3Q. While rebuilding the sales team, WBD has also been canceling underperforming cable shows. How could they sell advertising for those shows during the turnover? Also hurting were tough comps with NBA playoff games and the Olympics in 3Q21. That cost advertising about 300bp. Sports for late 2022 and into 2023 are showing higher viewership now at this point.

- Streaming's relaunch along with AVOD platforms will allow for additional advertising revenues, especially with a free streaming service that is advertising-supported. With much of that rolling out in 2023 and beyond – advertising could get some long-term tailwind simply by having more areas to sell it.

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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