BEHIND THE NUMBERS
Quality of Earnings Analysis
October 21, 2022

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Behind the Numbers

Companies in this Issue

Ares Capital Corporation (ARCC) p. 1
International Business Machines Corp (IBM) p. 7
McCormick & Company, Inc. (MKC) p. 9
Procter and Gamble Company (PG) p.10

Ares Capital Corporation (ARCC)
Resuming Earnings Quality Coverage

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are resuming earnings quality coverage of ARCC with a 4+ (Acceptable) rating.

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

We are resuming our coverage of ARCC, which we dropped after 1Q21. The reason we dropped coverage was not due to a downgrade or a problem. We were following several catalysts such as:

- The stock was attractive below book value and by 1Q21 was at a premium.
- Covid saw fewer deals and thus fewer capital fees earned – that had normalized.
- It was boosting its debt-to-equity ratio with more investments already.

All of those catalysts were gone. The reason we are resuming coverage ahead of 3Q earnings is we think there are catalysts building now. Primarily, rising interest rates could drive earnings and dividends higher in the coming quarters based on their floating-rate investments. They are seeing stronger loan documentation and there is less competition from banks. Plus, duration may extend as rates increase.

- The stock is back under June 30, 2022's book value of $18.81. Unrealized losses in the 2Q were $194 million which cut 39 cents off book value too.
- 3Q unrealized losses may have increased further to skew the book value again – we expect very few of those losses will be realized.
- The BDC structure requires ARCC to pay out the bulk of earnings as dividends – and the dividend is already increasing and supplemented further with special dividends. The yield is over 10% now.

What to Watch

- **Spillover income is estimated at $1.41 per share. This represents undistributed income that tax rules require ARCC to distribute over time.** Currently, ARCC is paying a special dividend of 3 cents per quarter to deplete some of this. Yet, it still grew to $1.41 from $1.07 at the end of 2020. ARCC believes this provides a cushion to maintain dividend levels even during market chaos.
- Spillover represents Core EPS that exceeds the dividend, which ARCC has been seeing for some time now. Core EPS is GAAP EPS plus unrealized gains/losses plus incentive fees paid on capital gains, both realized and unrealized. Already the dividend is rising and the latest one is $0.46.

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Core EPS	$0.46	$0.42	$0.58	$0.47	$0.53	$0.43	$0.54
Dividend	$0.45	$0.45	$0.41	$0.41	$0.40	$0.40	$0.40

- **The bulk of investments are floating rate (87% at the end of 2Q22 per the earnings presentation) and they reset every 3 months.** Also, ARCC puts interest rate floors on these investments which preserved some interest income when rates declined during Covid. However, rising rates only help earnings once rates become higher than the LIBOR/SOFR floors. Until then, ARCC sees the floors still generate more income. Only in 1Q22 did interest rate hikes start to move the bulk of these securities above the floors.
    - A 100bp move from where rates were at the end 2Q22 would add 31 cents per year to annual EPS.
    - A 200bp move would add 51 cents to annual EPS.
    - This is for a company with trailing annual EPS of $1.93 AND – it needs to pay out 90% of earnings as dividends to avoid federal income taxes and 98% to avoid a federal excise tax.
    - The dividend is currently 10.2% on an $18 price. The dividend is already growing and could well continue to rise with interest rates.

- **2Q22 did not fully participate in the interest rate increase for several reasons:**
    - Not every loan reset at the higher rates by the end of the quarter.
    - Some loans are still below the floor amount.
    - The rate increases occurred well into 2Q22. The 25bp hike on March 17, was fully seen in 2Q, but the floors likely were still the main player after that hike. The 50bp hike on May 5 would only have impacted loans for only 56-days. The 75bp hike on June 16, would have only impacted 2Q for 14 days.

- Management estimates that had all the rate hikes been in place for the full quarter, it would have added 8 cents to EPS instead of 5 cents.

- **3Q22 should see the full impact of 2Q rate hikes and will see some rate hikes of 75bp more on July 17 and 75bp again on September 21.** The forecast is that 2Q hikes should be 8 cents in extra EPS per quarter. The 3Q hikes represent another 150bp, which may add another 7.5 cents when all the increases are in effect for loans.

- **At the same time, ARCC funds its balance sheet with debt too – it had $11.76 billion in debt at the end of 2Q22. Of that debt, 72% is fixed rate** and there is only $750 million due in 2023 and another $1.3 billion due in 2024. Thus, the lending spread is getting wider. Early in 3Q, ARCC issued 9.2 million shares of stock at $19 and used the $174 million to retire borrowing on the credit line.

- **Credit quality appears solid and could be improving as ARCC is seeing more documentation in loans, tighter covenants,** and banks are looking to sell deals rather than compete on making new ones. That is helping on documentation too but also spreads on deals are widening building more cushion in on pricing and enabling more fees. Fewer deals are selling junior tranches too. Here is what the CEO said on the 2Q earnings call:

> *"…**banks have underwritten some transactions that they are looking for liquidity** on, right? That's probably going to continue through the remainder of the summer and even into the early part of the fall. So all it's done is simply widen, what we're seeing in the public markets. And thankfully now, I think we and **most of our other friends and competitors in the private lending space are widening pricing out as well. So an early just preview is probably an additional 100 basis points of spread across most of the tranches as well as higher fees.***
>
> *And **we're also benefiting to your question from much more lender-friendly documentation, you have reemergence of covenants in some of the smaller deals that perhaps tried to shed covenants during our froth year period**. So pretty much every aspect of the investing environment, from pricing terms and documentation has all improved materially in the last 30 to 60 days."*

- We will emphasize that ARCC has always had good credit quality as it is picky. Only about 4% of deals it looks at get funded. Also, the bulk of their credits are firms that have grown with ARCC and borrowed from them for many years, so they have a history with the management and the company. Because it is the largest BDC – it does not compete with new players for larger deals. Y/Y twelve-month EBITDA growth for the average firm in its portfolio was 16%. It is dealing with more mature companies too as the average size EBITDA is $179 million. There is almost no exposure to cyclical industries like travel, steel, or oil & gas. They do have a portfolio weighting of 23% toward software and 11% toward healthcare. Loan-to-value is under 51%.

- ARCC's goal is to hold Debt-to-Equity at a maximum 1.25x. It was at 1.27x after 2Q22. ARCC sold $174 million in new equity in 3Q22 – assuming that boosted equity and retired debt, the ratio would be 1.22x. ARCC has the ability and the liquidity to go above its target ratio. However, we would view ARCC as unlikely to push it much further due to:

    - Mark-to-Market losses may be higher in 3Q than the $194 million in 2Q. While these are unrealized losses, they reduce the equity base and boost the ratio.

    - There would be some principal repaid on loans too – that would bring the ratio back down as well.

    - We do not think ARCC will look to expand the portfolio in total size very much. However, it could sell down some positions and look at adding more investments at wider spreads.

    - ARCC may also have to consider that the IPO market is not as attractive now either which could stretch duration more on the investments.

    - A couple of years ago, the debt-to-equity was under 0.8x – keeping money at work was a tough job because it was prepaying as fast as new loans were being made. One of the catalysts for ARCC was going to a 1.25x figure. We don't see that catalyst now.

- However, there is a hidden benefit now of being fully invested. There should be less of an issue from holding too much cash earning 0% while ARCC was paying 10% in capital costs for the dividend and 4%-5% on some of its debt.

International Business Machines Corporation (IBM)
Earnings Quality Update

We are maintaining our earnings quality rating of IBM of 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

IBM's 3Q22 non-GAAP EPS of $1.81 was down y/y from $1.84 despite a 6.5% increase in revenues. The $1.81 beat by 1 cent. As usual, IBM is waiting to release its 10-Q where we can see some of the primary levers they pull for quarterly earnings. So, we will update 3Q22 results a second time after the 10-Q is available, but so far we are not impressed with results at all:

- **We believe depreciation is down as much as $132 million y/y – that would be 12 cents of additional EPS.** In the press release, IBM combines depreciation and amortization on the cash flow statement but breaks it out in the 10-Q. It adds back amortization of acquired intangibles to non-GAAP EPS. We know that amortization through June was essentially flat y/y at $1.25 billion. We are assuming that happened again in 3Q as we don't have the 10-Q yet.

  In the 3Q22 press release – IBM reports Depreciation and Amortization fell from $1.684 billion to $1.163 billion. In 3Q21, Kyndryl was still in the mix and it had depreciation of $389 million. If we adjust for that, D&A for IBM still fell from $1.295 billion to $1.163 billion – it fell for IBM by $132 million. The part that is depreciation in that decline would drive EPS – and $132 million is 12 cents.

- Stock compensation fell $11 million y/y – that added 1 cent.

- The tax rate came in at 15.9% vs. guidance for mid-high teens. 100bp of higher tax rate is 2 cents of EPS.

- **Why is inflation and wage growth still rising everywhere – except for IBM's R&D spending?** IBM said again that gross margin is declining due to inflation. IBM normally looks like it is buying its R&D via acquisitions and then assigns the cost to goodwill and amortization of intangibles that it adds back to non-GAAP EPS, so presto – there is no

cost to an acquisition in IBM's non-GAAP EPS. However, YTD in 2022, acquisitions are only $1 billion, down from $3 billion through 3Q21 and only $62 million in 3Q22. **R&D fell as a percentage of operating revenues by 94bp – That added 12 cents to EPS.**

- Non-GAAP SG&A fell by 158bp as a percentage of operating revenues (no "other" or financing revenues). That certainly helped EPS – which again was down y/y. We need the 10-Q to look more closely as SG&A is where the workforce rebalancing and bad debt expenses are located.

- 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 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. Kyndryl reports earnings for September in two weeks. It guided to -3% to -4% constant currency growth for its year and affirmed that after June results. 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.

McCormick & Company, Inc. (MKC)
Earnings Quality Update

We are reducing our earnings quality rating of MKC to 3- (Minor Concern) from 3+ (Minor Concern)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

MKC reported non-GAAP EPS of $0.69. The stock was already down from its September 7 pre-announcement where it forecast $0.65 in non-GAAP EPS and warned of moderating consumer demand and ongoing supply chain problems.

- We note that the company recorded an $18.7 million gain on the settlement of treasury locks in "other income." The company entered into the arrangements in May to manage interest rate risk from fixed-rate debt it expected to issue. While they were designated as hedges with gains and losses to be recorded in accumulated comprehensive income, the company never issued the debt resulting in the settlement proceeds being recorded straight into "other income/expense." The company noted in its May 10-Q that it expected to record an approximate $15 million benefit from these contracts. However, we saw no mention of the benefit in the latest quarter's conference call or press release although it was cited briefly in the MD&A of the 10-Q. We question why this amount was not removed along with its other non-GAAP adjustments including the gain from the sale of Kitchen Basics and its $3.4 million in Transaction and Integration expenses which it added back to non-GAAP profits. The total proceeds from the locks added about 5.5 cps to non-GAAP EPS. We doubt this was accounted for in most analysts' models but even if it was, the amount was almost $4 million higher than the company's forecast in the 5/22 10-Q which amounted to over a penny per share.

- MKC's inventory DSIs have been climbing for the last three quarters and are well above pre-Covid levels. The company has noted that it has built safety stock to deal with its ongoing supply chain problems. It plans to reduce its inventories going forward and has cited that as one of the factors that it expects to continue to negatively impact margins.

Procter & Gamble Company (PG)
Earnings Quality Update

We are maintaining our earnings quality rating of PG at 4- (Acceptable)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

PG reported EPS of $1.57 for the 9/22 quarter which was 2 cps ahead of expectations. The company lowered its revenue growth guidance for the year ended 6/23 to -1% to -3% from its previous range of 0-2% reflecting expected FX deterioration but left its organic growth target of 3-5% intact. It also left its full-year EPS growth guidance of 0-4% in place but is now guiding to the lower end of that range.

We saw several one-time effects working both ways in the 2 cps beat:

One-time negative impacts:

- A higher-than-forecast tax rate cost approximately 5 cps.
- Lower gains from asset sales cost about 2 cps

One-time benefits:

- An unusual decline in depreciation expense added over 1.5 cps.
- An increase in other income due to a one-time realized loss on equity investments in the year-ago period added about a penny
- The company said that marketing expense fell by 200 bps a percentage of sales due to increased marketing efficiencies. We estimate this added 13 cps to earnings. We are skeptical that the company can continue to see this type of benefit and raise prices as rapidly as it is doing to offset costs.

- The company does not quantify promotional spending but noted stated in the call:

> *"On the price and promotion side, Jason, we've seen promotion levels come down during COVID, as you know, from above 30% pre-COVID to, I think, 16% [Phonetic] was the low during the COVID period. We now see in our categories, promotion coming back up somewhere between 27% to 30%, which is to be expected. For us, the most important element is to use promotions in the right way."*

  Increased pricing added 9% to revenue growth in the quarter. It is important to remember that the 9% is net of the impact of promotional spending which already appears to be increasing and pressuring growth.

With the exception of the marketing cuts, the one-time negatives outweigh the benefits so we are not overly concerned by the accounting quality of the quarter.

Other Items to Watch

- Inventory DSIs rose YOY by 8 days to over 64 in the quarter which is well above pre-Covid levels. This warrants watching in future quarters as excessive inventory, particularly for a company using FIFO inventory accounting, could pose a problem if it runs into trouble increasing prices in future quarters.

- Despite the rise in inventories, days payable on a quarterly basis fell slightly. This is the second straight quarter of payable declines after a string of rapid increases. It appears that the company's expansion of payables, which has been in part due to its SCF program, has reached its limit which may continue to be a drain on cash flow in upcoming quarters.

- We have warned that as of the 6/22 annual impairment review, the fair value of the company's *Gillette* indefinite-lived intangible asset was only 5% above its carrying value which increases the risk of another writedown. At that time, the company stated that a 25 bps increase in the discount rate used to value the asset would result in a 6% decline in its value. PG admitted in the 10-Q that during the 9/22 quarter, an exchange rate

devaluation and change in cost of capital inputs “increased pressure on the fair value of the Gillette indefinite-lived intangible asset.” However, the company still concluded that there was no triggering event to warrant another impairment test. The carrying value of the asset is $14 million and we continue to see the risk of another writedown as high, especially given the Grooming segment experienced a “mid-single-digit” decline in revenue in the 9/22 quarter.

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

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.