BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

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Altria Group, Inc. (MO)
Earnings Quality Update

We are maintaining our earnings quality rating MO at 2- (Weak).

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

Summary

MO's 3Q22 adjusted EPS of $1.28 missed forecasts by 2 cents. We think the situation is worse than that after considering some one-time issues:

- Last year, MO was still ramping up retail marketing for the IQOS roll-out which was banned in 4Q21. We estimate that 3Q21 had $50-$60 million of spending in this area that did not occur at all in 3Q22 – that is about 2 cents in EPS.

- General Corporate expenses declined by $63 million y/y in 3Q22. We noticed that $50 million was due to lower health care and litigation costs. Given MO's litigation exposure, this could rebound. That $50 million in savings was 2 cents in EPS.

- There was another 2 cents added back for litigation as an adjustment to EPS, again – when is this NOT recurring?

People own MO for the dividend that at $0.94 is $1.6 billion per quarter. MO still relies on smoking for 90% of its operating income which is needed to pay the dividend. There is some seasonality to results with smoking income of $2.5 billion-$2.8 billion per quarter. With $270 million in quarterly interest payments and 25% in taxes, MO's smoking unit is producing $1.7-$1.9 billion in quarterly cash income to cover the $1.6 billion dividend.

But the bombs keep coming for smoking…

What to Watch

- **Three-quarters of California citizens voted this week to ban menthol and all flavorings in cigarettes and vaping. The law already exists** and was suspended from taking effect until the vote was taken. Menthol is about 30% of the total cigarette market. We have written about several medical studies that show menthol increases the chance that people will start smoking and smoke more often. Menthol cigarettes have also shown less decay in volumes than other cigarettes and were viewed almost as a growth market for the tobacco companies. A ban in California could spread and the FDA is working toward a nationwide ban as well. We think this is likely to hurt MO's cigarette volumes going forward. Graphic health warning pictures will go on cigarette packs in 2023 too. That also has proven to lower smoking volumes in numerous countries.

- **Volume is already plummeting for MO and it has accelerated in recent years.** Levels of decay used to be 4%-5%, now it's 8%-10% and that's compounding. That is being hurt more by inflation, especially for gas prices and food. 3Q saw this continue to be ugly:

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 been taking huge price increases to offset the volume decay, which may also be helping accelerate the volume decay. Consumers are also trading down to discount brands – which have gained about two percentage points recently. In 1993, when Altria was still part of Philip Morris – the company had been following the same growth plan of continually raising prices for Marlboro cigarettes. However, many customers began to resist the higher prices and traded down to discount brands. This led to a day called Marlboro Friday, where Philip Morris slashed prices on Marlboro to protect its market share. With Marlboro seeing rates of decay in excess of the market, we wonder if Altria can still take enormous price hikes. Volume decay is exceeding pricing power now for smoking at MO:

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

It is interesting to note that both 1Q22 and 2Q22 reported lower promotional spending. Promotional spending lowers net sales as a reduction in pricing. In 3Q22, promotional spend was up y/y. The more volume decay accelerates, the more MO relies on higher pricing to offset it. Results are already showing it can't continue. We know in 3Q, smoking income was up $51 million y/y. However, we also know that 3Q21 had marketing for the now defunct IQOS deal with PM and it had higher litigation costs. It looks like smoking income is already falling. 2Q22 smoking income was up $16 million with the same factors at work.

- The new plan is a joint venture with Japan Tobacco to sell their heated tobacco products in the US. MO will get 75% of the income and JTI will get 25%. The new product has to be approved by the government agencies and that will take many quarters – meanwhile, the basic business is in decay. We see the same problems they had with JUUL: 1) this new product is designed to cannibalize regular cigarettes, 2) MO gets 100% cash earnings from cigarettes, it was getting 35% of non-cash equity income earnings from JUUL and would get 75% cash earnings from the JTI deal which accelerates the cash

flow decline, 3) rolling out the new product will cost much more money in marketing and promotion, in setting up production lines in the US, in getting it into distribution systems – The first $150 million is on MO, then those costs are split 75/25. This also will likely be a less profitable product that is taking share from the cash cow.

- MO paid $12.8 billion for 35% of JUUL less than five years ago. It had another writedown in 3Q and that investment is now valued at $350 million. It borrowed the money and will have to service that debt with no cash flow from JUUL. The deal also brought them more litigation exposure. MO faces 58 class action lawsuits, 3119 e-vapor lawsuits, and 1174 third-party lawsuits from JUUL that include school districts, local governments, and healthcare organizations. These are all future cash expenses even if it only has to pay litigation costs and no damages – that will be funded out of smoking cash flow. The money from PM for getting out of its IQOS deal is $2.7 billion and is not going to cover the JUUL debt, the lawsuits, and the roll-out of the new heated tobacco JV.

- We had always wondered how long MO could carry its ABI investment at levels that far exceeded fair market value as the price of ABI stock was easy to see – plus ABI had reduced the dividend so MO was taking in less cash on the deal. In 3Q21, it wrote off $6.2 billion for this investment and now in 3Q22, it wrote off another $2.5 billion.

- Beyond getting rid of menthol and graphic packaging, the FDA is still looking at lowering nicotine levels in cigarettes. Studies have shown that is another game-changer in causing volumes to gap down.

Ball Corporation (BALL)
Earnings Quality Update

We are maintaining our earnings quality rating of BALL at 3- (Minor Concern)

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

Summary

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.

The Coca-Cola Company (KO)
Earnings Quality Update

We are maintaining our earnings quality rating of KO at 3- (Minor Concern).

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

Summary

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.
- Stock compensation fell in dollar terms despite higher sales and profits – that helped to a very minor degree.
- 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 (See Below). We would also be concerned that higher advertising may be more likely and we see several issues with inventory and gross margin (See Below.)**

What to Watch

- 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:

	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 190bp. 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:

    - KO uses a combination of 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 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%

- As noted above, advertising saw a sizeable jump y/y in 3Q22. That hurt margins by 150bp. We think continued large price increases may require higher advertising to remain part of the equation. Also, KO's total SG&A leveraged well and came in only $157 million higher on an extra $1 billion in sales despite the $278 million increase in advertising expense. **SG&A as a percentage of sales declined 140bp and offset the gross margin loss of 190bp. KO's explanation was that FX gave them lower costs overseas and led to an 8% decrease overall in SG&A which is $250 million or 5 cents in EPS. There's the EPS beat.** That was higher than 2Q22 when FX lowered SG&A by 6% or $181 million or 4% in 1Q which was $103 million. KO is guiding for FX to be -7% in 2022 after coming in at -8% in 3Q22, but that is expected to decline some in 2023 to a 5%-6% headwind. Lower FX pressure may be reducing pricing power, leaving KO with lower total revenue, higher advertising, and rising SG&A.

- 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.

Ecolab Inc. (ECL)
Earnings Quality Update

We are maintaining an earnings quality rating on ECL at 3- (Minor Concern)

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

Summary

ECL's non-GAAP EPS in 3Q 22 of $1.30 was in-line with the consensus estimate. However, we noted several one-time benefits without which the company would have missed.

- The non-GAAP tax rate fell to 18.3% versus 19.5% in the year-ago quarter. The company attributed this to certain discrete tax items. This was below the company's guidance and we believe it is reasonable to conclude that this provided about 1.9 cps of unexpected benefit to EPS in the quarter.

- Provision for bad debts expense fell by $3.3 million. We estimate that the decline as a percentage of quarterly sales added about 1.1 cps to earnings in 3Q22.

- The company added back a little less than a penny per share in Covid-related costs in the quarter. This adjustment continues to decline but we have to ask again why two years after the pandemic it is adding back $1.3 million to "protect the wages of certain employees directly impacted by Covid-19" and $1.6 million related to employee testing. While 1 cps may seem like nitpicking on our part, we believe practices like this weaken the overall quality of the company's reported earnings.

- The current charge did not include amounts for inventory writedowns but as we have addressed in past reviews, charges in past quarters included significant amounts to write down the value of Covid-related products. Management noted in the call that it continues to sell down these inventories. We wonder how much more profitable sales of these items are because of the writedowns that were ignored by non-GAAP earnings.

- The non-GAAP add-back for legal costs jumped to 3 cps in the quarter. ECL adds back 1-3 cps of "one-time" legal costs every quarter. If these are truly one-time, shouldn't they go away?

- The LIFO reserve increased sequentially during the quarter to $130.2 million from $124.1 million. We flagged the previous quarter's sequential decline which seems very unusual given the inflationary environment. We are less concerned about the inventory balance at this point.

The Hershey Company (HSY)
Earnings Quality Update

We are maintaining our earnings quality rating of HSY at 3- (Minor Concern)

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

Summary

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 adjusted 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, this adds to our concern about a potential volume disappointment in the fourth quarter given the weakening consumer footing.

Cloudflare, Inc. (NET)
Earnings Quality Update

We are maintaining our earnings quality rating of NET at 3- (Minor Concern).

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

Summary

NET's 3Q22 non-GAAP EPS of $0.06 beat forecasts, but there are several areas of non-operating items helping out, plus some reduced cash spending in key areas:

- Rising interest rates boosted interest income to $3.9 million adding 1.0 cent

- Other income – largely FX gains/losses – rose to $2.4 million adding 0.7 cents

- Actual EPS was 5.6 cents so rounding up added 0.4 cents

- Cash spending for R&D has always risen sequentially but that stalled in 3Q22 – at $46.4 million vs. $46.2 million in 2Q22. As a percentage of sales, that added 1.0 cent.

- Cash spending for Sales and Marketing had always risen sequentially, but it actually fell slightly in dollar terms in 3Q22. As a percentage of sales, that added 2.4 cents to EPS.

- The goal is to boost non-cash spending for stock compensation and therefore allow cash compensation to grow more slowly and leverage for higher non-GAAP margins. Headcount continues to rise, but Sales and Marketing not only received lower cash pay, their share compensation also went down.

Guidance looked poor as well for 4Q22. Revenue is expected to come in at or below the prior street forecast. The non-GAAP EPS is expected to be 4-5 cents vs. the 6 cents they just posted, which would indicate that some of 3Q's EPS is not sustainable given that there should still be sequential revenue growth to leverage non-GAAP margins a bit. NET specifically called out pricing pressures, FX pressures, and delays in signing in the APAC region.

We will update NET more fully with the rest of the industry in the near future, but here are a few other thoughts on NET's results.

What to Watch

- Share compensation fell from $57.5 million in 2Q to $55.9 million in 3Q. Headcount was up 4% at the same time. There was also $1.3 million of Area 1 stock option conversion that was amortized into the 3Q share compensation figure. We noted above that cash spending on overhead costs was flat to down on higher revenues and higher headcount. The share compensation is falling too. Can NET get away with lower total pay for people for very long?

- Revenue growth was weak and forecasts are for that to continue. Deferred Revenue rose, which is a positive and gives better line-of-sight to revenue forecasts. The downside is NET's high forecast only matched the street's 4Q revenue forecast figure:

	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

  4Q sales guidance of $273.5-$274.5 million would be 7.7%-8.1% growth for sales despite higher deferred revenue.

- Free Cash Flow remains negative despite high levels of stock compensation and Deferred Revenues. Free cash flow was -$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 no longer be the best currency.

- On the earnings call, NET said it's biased against acquisitions – yet it still made $93.8 million in deals in the last 12 months. That further reduces free cash flow. The largest one is Area 1, which was touted on the call, but even with that integrated and a full quarter of operations, it was less than 1% of revenues.

Starwood Property Trust, Inc. (STWD)
Earnings Quality Update

We are maintaining our earnings quality rating of STWD at 5+ (Strong).

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

Summary

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 still trades below book value of $21.69 and it believes fair market value for its property would add another $5.00 in value. It's yielding over 9% and likely to see dividend increases in 2023. Plus, Barry Sternlicht noted on the call, *"And what's really interesting about the firm is that if we don't make any more investments next year, we just hold the book we have and it should produce earnings that will cover our dividend."*

What to Watch

- STWD noted on the call that is being defensive at the moment and hoarding liquidity waiting for great bargains. It does not have to refinance debt, it does 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. It is hedged against base rates and FX but it cannot easily hedge against mortgage loans being priced at 300bp over treasury instead of 50-100bp. It noted that its Residential 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 widened and that hurt the value of the current portfolio with a $92 million unrealized mark-to-market hit for GAAP purposes. STWD sees 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. It is likely to redeploy payments that are received but will continue to hold its $1.3 billion in liquidity for now.

- The potential that STWD sees in the market:

  Jeff DiModia – President:

  > *"We've recently been more selective. That said, we are seeing great investment opportunities today, not just in CRE (Commercial Real Estate) lending where we are seeing mid-teens returns on equity, the highest in my term as President, but also in energy infrastructure where LTVs (Loan-to-Values) are down, unlevered coupons are up and financing is abundant and stable.* ***This new capital gives us the most liquidity we have ever reported, $1.3 billion of dry powder."***

  Barry Sternlicht:

  > *"So, I would say that the most important thing I would tell you about us is, we're on defense. We're not really on offense. We have the record liquidity of $1.3 billion. We raised the $600 million debt deal last week – earlier this week, I guess it was. It was last week, closed this week. And we're going to be very careful where we deploy the capital. It is – the market opportunity for us is as good as it's been since we IPO-ed the company in 2009. Not only the banks pulling back on credit given the craziness of the Fed, nobody knows what to do.* ***So the banks are not only***

not lending, but they're reluctant to do anything, frankly. That creates unbelievable opportunities for companies like us."

- 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, they saw 100% of the rates on their loans exceed the interest rate floors they have 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 financed on fixed cost debt too, 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 servicer for more deals. This is lumpy income, but it is now 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.

Explanation of EQ Rating Scale

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

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

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

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

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

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

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

Key Points to Understand About the EQ Score

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

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

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