BEHIND THE NUMBERS
Quality of Earnings Analysis
November 4, 2022

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Behind the Numbers

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Air Lease Corp. (AL)
Earnings Quality Update

We are maintaining our earnings quality rating of AL at 4+ (Acceptable).

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

Summary

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 and its press releases note that six placements occurred in October.

- We still see book value at $59/share vs. the share price of $34-$35. 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 is $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 rising 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.

LyondellBasell Industries N.V. (LYB)
Earnings Quality Update

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

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

Summary

LYB's 3Q22 EPS of $1.96 missed forecasts badly by $0.97. This did not have an earnings quality problem. There were $0.21 in charges related to exiting the refinery. This was a known event, and LYB guided to these charges recurring for the next five quarters.

The miss stems entirely from downtime at many of the European facilities due to higher operating costs for feedstocks and electricity. Also, China imports a large percentage of its chemicals and chemical feedstocks and with periods of Covid lockdowns in 3Q, Chinese demand was down too. Both of those events were also known during 2Q and LYB was already pointing to weakness continuing in 3Q. The degree of the slowdown was the miss. The miss was $315 million of EBITDA and sequentially EBITDA declined from $2.45 billion to $1.2 billion. Thus, they were already pointing out that a significant drop was coming.

Guidance for 4Q is based on weakness from seasonal factors plus lower demand as China has not fully reopened. That lower demand means LYB is going with lower operating rates and some of the capacity that went offline in 3Q for maintenance will not restart until 1Q23. Energy costs are expected to remain volatile and European operations will be where much of the reduced production will occur.

What to Watch

- The falling costs for feedstocks and chemical selling prices are freeing up working capital and helping cash flow. 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.

- Inventory DSIs 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 3.1x mid-cycle EBITDA for the valuation here. Plus, LYB continues to retire shares.

Mohawk Industries, Inc. (MHK)
Earnings Quality Update

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

MHK hit earnings estimates on the nose 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.

Sealed Air Corporation (SEE)
Earnings Quality Update

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

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

Summary

SEE is one of the great adventures to review every quarter. It beats forecasts, but this doesn't seem to translate into higher expectations. After beating forecasts by 8 cents in 3Q22, SEE cut guidance:

2022 Guidance	Beat	EPS Range	EBITDA	Sales	Free Cash Flow
After 4Q21		$3.95-$4.15	$1.20-$1.24b	$5.80-$6.00b	$510-$550
After 1Q22	$0.19	$4.05-$4.20	$1.22-$1.25b	$5.85-$6.05b	$510-$550
After 2Q22	$0.05	$4.05-$4.20	$1.22-$1.25b	$5.85-$6.05b	$510-$550
After 3Q22	$0.08	$4.05-$4.15	$1.21-$1.23b	$5.65-$5.75b	$460-$500

SEE has had a cumulative beat on EPS of $0.32 YTD and after only raising its range by 10 cents on the low end after 1Q, it just cut the top end back to the forecast in place at the start of the year. This is even worse than it looks at first glance. SEE began the year predicting 150 million shares, that's now down to 148 million – that alone added 5 cents to the low end and 6 cents to the top end. Also, it started the year with a 26% tax rate, which has been reduced to 25.5% after 3Q. That adds another 3 cents to EPS. SEE beat by 32 cents and added 8-9 cents of extra tailwind – and the forecast is for 2022 to come in 10 cents above the low-end and flat with the high-end prediction to start the year.

Sales growth is now expected to be less than guidance to start the year. Why? They are getting killed on negative volume as the company raised prices. Some of this is China lockdowns too, but that was known in 2Q and SEE didn't cut sales forecasts until now.

How about the 8-cent beat overall on quality/sustainability? SEE has seen some recent tailwinds reverse:

- The tax rate rose 70bp and hurt EPS by 0.8 cents

- Share compensation and profit sharing $3.3 million rose and was a 1.7-cent headwind

- Inventory reserves rose by $5.5 million and was a 2.8-cent headwind.

- SEE added back consulting fees again for $1.6 million or 0.8-cents of tailwind

- Realized gains on FX contracts helped by $4.8 million or 2.4-cents

These items net out to a 2.1-cent headwind and bad debt expense was zero. From that standpoint, the 8-cent beat looks real. However, we would argue that massive price hikes of 12.5% far exceeded inflation and led to $71 million in higher EBITDA for as much as 36 cents in EPS. Every 1% of the 12.5% that SEE cannot sustain would cost it 7 cents in EPS.

- Investors should be concerned that Volume is still weak. We'll give them some excuse on China with lockdowns in 3Q, but their weakness isn't coming from there. We're not excusing North America and not accepting supply disruptions being a major issue still as the US chemical companies are talking about oversupply and lower prices. The Americas division is two-thirds of sales and its volume is collapsing. SEE is talking about customers cutting their inventories of supplies and losing market share that it hopes to win back. That does not sound like supply chain problems to us:

	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 tends to unwind operating efficiency, but SEE is still getting gross margin gains from the huge price hikes. We know much of the pricing is due to index-related pass-throughs on commodity cost changes. If 3Q22 results had 100bp less pricing, sales, and gross profit would have been $14 million lower, resulting in 70bp of lower gross margin and 7 cents in lower EPS.

- SEE uses FIFO accounting. That helps gross margin during inflationary times. SEE's inventory is starting to stack up. It is normally 70 days. It was 87 days after 2Q22 and was 92 after 3Q22. SEE could end up in a situation where it is carrying high-cost inventory and it is lowering selling prices – crimping gross margin. The FX headwinds won't help pricing either.

- Price/Cost pass-throughs for commodity prices with customers work with inflation and deflation. The prices for plastics and paper have been falling for months now, and SEE is still seeing hefty pricing coming through. They have been getting price/cost adjustments of positive $100 million per quarter – normally that's +/- $10-$25 million. Losing steam in this area may be part of the reason for lower sales and EPS guidance. (**See Below).**

- SEE changed its metric of Price/Cost to net other operating costs in the mix. This makes the commodity amount tougher to isolate for how far ahead SEE is on taking pricing. Clouding the financial picture in this way rather than reporting all costs separately is seldom a positive in our view. **(See Below).**

- SEE is also acquiring Liquibox – we will discuss this more when the documents are complete. It does create more food-related sales for SEE, which is likely a positive as they have less volatility.

What to Watch

- **SEE changed its presentation again without explanation.** The last time was when it split Latin America into South America and Central America joined North America. That really highlighted how much organic growth SEE was picking up via price hikes before it subtracted the FX hits in South America and it had no problem reporting at 5% of its total sales with negative volume was routinely more than half the total company's sales growth excluding FX. Before those huge imaginary price hikes could anniversary as tough comps, SEE changed again and rolled South America into North America, and North America has gone from an immaterial FX hit to a decent-sized one offset by the inflationary pricing from South America that started long before 2021. **We consider this**

a big red flag. Anytime a company provides less data and makes it impossible to track apples-to-apples ratios, trends, etc. – it looks more like an attempt to cloud the issue and suddenly tout a benefit that may be more illusionary. As soon as South America and its hyperinflation were added to the America's, the negligible growth rate of its largest division suddenly took off based on South American pricing:

- **This time the change is the Price/Cost figure.** SEE has terms with many customers that lets it pass through commodity costs on a lagging basis. Some of these are set by indices that change throughout the year too. **The goal of this setup between SEE and its customers is to have the price and cost impacts of commodities net to zero over time. As inflation in commodities is starting to come down, this price/cost seemed likely to decline** through much lower price increases or decreases and shrink the earnings benefit SEE had enjoyed. The key is this was to net out commodity price changes both positive and negative. If SEE's operating costs rose while pricing was falling – that was its tough luck.

  SEE has been running far ahead of zero in this regard and as noted above, the high pricing gains are the primary boost to EPS.

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

Suddenly in 3Q22, SEE is now reporting Net Price Realization. This new figure is Pricing Change – Direct Material Inflation – Non-Material Inflation – Labor Inflation. The three costs are not broken out separately and much of the new total higher costs are not part of the original Price/Cost spread arrangements – which are what drive pricing. The figure given for 3Q22 was $71 million for Net Price Realization. That looks much lowers than 2Q22 and 1Q22, but is it really?

	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

To muddy the waters more, SEE has additional operating costs broken out now, but not described. For 3Q22, this was $5 million and YTD $37 million of higher costs. Adding all the net pricing ($71 + $56 + $68) we get $195 million and the if we add back the $32 million in operating costs that are now pulled out of 2Q and 1Q – the new figure is $227 million which foots to the company's $228 million likely with some rounding. But consider the following:

- All the company's beats of late are much lower than what this additional pricing less cost inflation has provided in the three quarters for 2022. When SEE is getting $70 million – it's worth more than 30 cents in EPS per quarter.

- Remember, that Price/Cost is still supposed to net out to zero over time. We know resin prices have been falling significantly for months now and paper prices have been falling since May. There is a lag between cost changes and passing it through to customers via pricing – but SEE was getting $100 million increases for Price/Cost in recent quarters vs. normal changes of $10-$25 million. There may be more pressure coming for SEE to give back pricing.

Sysco Corporation (SYY)
Earnings Quality Update

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

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

Summary

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. **(See detail below)**

- 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.

- Management noted it will be recording a $250-$300 million non-cash charge later this year related to transferring its pension obligation to an insurance company.

Change to Measuring US Foodservice Volume Growth

US Foodservice is SYY’s largest segment accounting for roughly 60% of sales. Historically, the company has reported case volume growth for its US Broadline business which does not include its specialty operations. However, in the 9/22 quarter, the company began including the volume from its US FreshPoint produce operations and its US Italian Business. These businesses have received a boost from acquisitions over the last couple of years including the Greco acquisition which closed in the 10/2/2021 quarter and the Coastal deal which closed in the 4/22/2022 quarter. ***This would have resulted in a significant non-organic boost to the growth figures.***

SYY included historical growth figures restated for the new method in its investor presentation. We compared the restated historical growth volumes for both US local accounts and total US Foodservice to the originally reported volume growth figures in the table below:

	10/1/2022	7/2/2022	4/2/2022	1/1/2022	10/2/2021	7/3/2021	3/27/2021	12/26/2020
US Foodservice Volume- New Disc.								
Local	5.4%	8.7%	22.3%	23.9%	26.7%	58.0%	-10.4%	-19.9%
Total USFS	7.3%	12.0%	24.7%	27.3%	30.5%	57.8%	-14.7%	-24.2%
US Foodservice Volume-Old Disc.								
Local		-7.8%	14.1%	17.6%	23.8%	74.3%	-9.7%	-19.7%
Total USFS		-2.1%	18.8%	22.5%	28.1%	71.4%	-14.1%	-23.7%

We can see that in the last three quarters that the new volume disclosure method resulted in a 4-16% increase in the reported volume growth for total US Food Services growth. This means that volume growth in the core business for the 10/1/2022 quarter could have been negative had it been calculated under the old method.

This did not go unnoticed on the conference call:

Analyst:

> *"The clarification is just on the case volume growth that you're reporting. I think it's now including M&A. So it's just curious. Do you think that's right? And I don't know if you can give us some comparability versus the numbers that you've been providing, so we just know what's going on here underneath of M&A."*

Aaron Alt:

> *"From the outside, you might say, well, are you lumping the recent acquisitions in and that's a small part of what's in the case volume disclosure. But keep in mind that we have had a multibillion-dollar business what we call specialty, which is part of U.S. Foodservice, the segment we do most of our disclosures against that is not part of the U.S. Broadline. And so I want to take you back to the why, and we're now disclosing a total U.S. Foodservice number, it's simply this. The Recipe For Growth is designed to bring all of our assets to bear in support of specific customers. And we have customers that are serviced by Broadline, serviced by specialty. Kevin will probably comment on that more as we carry forward. What we're trying to give you the true view of what's going on with our total case growth and our local customer growth as we push ahead."*

Later in the call the topic came up again:

Analyst:

> *"Thanks very much. First, Aaron, just a follow up on the change in the way you've disclosed the case growth information. If I look back in the last few quarters, there's a pretty big difference between what you are now reporting and what you did before six, seven points in the last couple of quarters. Is that similar this quarter? In other words, we're trying to figure out how to look at your case growth versus maybe what we had estimated. If you could just, comment on the difference between what the old version versus new version."*

Aaron Alt:

> *"Let me address the first question. If you turn to Page 18 of our presentation, we actually give you the history, so you don't need to do the back calculation of the relative difference both versus prior year and versus fiscal 2019. And to emphasize, we have a couple – even pre-acquisitions, we had a couple of billion dollars of business that is very focused on both growth, consistent with the Recipe For Growth and serving the local customer individually and in partnership with our Broadline operators. And thus our belief is it's better for us to disclose the impact of the Recipe For Growth on the total U.S. portfolio in that way, which is what you see on Page 18."*

Warner Bros. Discovery, Inc. (WBD)
Earnings Quality Update

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

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

Summary

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. It was also impacted by changes at WMB.

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. WBD also boosted its synergy targets which it hinted at after 2Q's announcement as it was expanding the total restructuring and rebuilding efforts. 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. orginial plans for the summer of 2023. Also, plans were for streaming to break even on EBITDA in 2024 and post $1 billion in 2025. On the 3Q call, management said it plans to make bigger changes in 2023 toward achieving that.

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 too.

What to Watch

- 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.
    - Also hurting ad revenue was WBD rebuilding the sales program for selling advertising in 2Q and 3Q. Per David Zaslav, "*And **we spent the last four months reorganizing the ad sales team. We had a broad restructuring, including having sports and news be organized and sold with entertainment and nonfiction as one full service offering.** It was an awful lot of work and we're glad to have it behind us. The team is led by the superb, Jon Steinlauf, who has a great track record of outperforming the market, and did so for us in the five years following the Scripps acquisition as he led our team at Discovery.*"
    - 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.

- We don't think the streaming forecast is being given enough weight. The focus has been on simply adding starting EBITDA and $3.5 billion of cost synergies to get the outlook for 2024. YTD, streaming is -$1.8 billion in EBITDA and likely finishes at -$2.2 billion in 2022. That is expected to be the peak loss. The forecast is for streaming to post $0 in EBITDA in 2024 and $1 billion in EBITDA in 2024. That's a $2.2 billion swing in two years and $3.2 billion in three years. Some of that improvement is part of the $3.5 billion in cost synergies, but it's certainly not all of it.
    - WBD is accelerating the roll-out of the new streaming service platforms and content by 3-4 months in 2023. That may help pull the total streaming forecast forward too.
    - Management noted on the call that the live sports isn't missing the fact that Warner has a platform with 95 million subscribers that it intends to grow with a free subscription advertising-supported platform too. That could result in more revenue synergies going forward and more advertising.
- The messiness of 2Q and 3Q is creating tailwinds going into 2023. There is cost-cutting evidence already with SG&A costs dropping, with staff cuts happening. We already know there were some advertising issues with staff turnover and less content. Also remember, WBD canceled movie releases that would have happened in 2022 and early 2023 – that created more revenue holes. At the same time, it ramped up new content spending to rebuild the pipeline. 2022 also had spending that was junked like CNN+ that won't recur and there was more focus on restructuring HBO Max than pitching it to more new subscribers before the revamped roll-out. All these actions should help revenue growth and many past costs won't recur which are the synergies being touted.

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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