BEHIND THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

Companies in this Issue

Ball Corporation (BALL)
Earnings Quality Update

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

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

Summary

BALL's 4Q non-GAAP EPS of $0.44 per share missed consensus estimates by 11 cps as revenue fell over $140 million short of expectations. North American revenue is being pressured by lower volume as beverage companies, particularly beer, raised prices and cut promotional spending which resulted in higher-than-anticipated unit sales declines. Cash flow remains pressured as the inventory buildup and higher metals costs resulted in huge inventory balances

that have yet to be monetized. The company expects a $200 million benefit during the year as contract resets will allow it to catch up on its cost pass-through provisions while costs hopefully decline. However, there were some one-time benefits in the quarter investors should be aware of:

- Factored receivables jumped both sequentially and YOY despite the sequential drop in sales. BALL continues to boost its cash flow by more aggressively factoring despite rising rates making these programs more expensive. The company disclosed in the 10-K that the cost of its factoring program rose to $67 million in 2022 compared to $41 million in 2021 and $29 million in 2020. ***(See below for detail)***

- DSOs adjusted for factoring rose by 8.5 days sequentially and 4.3 YOY which could indicate revenue benefitted from late-quarter sales. ***(See below for detail)***

- BALL's inventories have been rising due to higher costs as well as an unplanned build from lower-than-expected revenue in the back half of the year. This is pressuring the company's cash flow as it has yet to monetize these inventories. Profits have also been pressured as efforts to control the inventory build have driven up per-unit costs. Margins will continue to be pressured towards the beginning of 2023 as high-cost units are expensed and the benefit of its cost pass-throughs will be limited until large contracts reset after 2Q23. ***(See below for detail)***

- Despite the increase in inventory, the company's reserve for obsolete inventory trended down in 2021. The reserve as a percentage of gross inventory now sits at 4% compared to its 6% level pre-Covid. We estimate it would take roughly 11 cps in charges to return the reserve to that level. ***(See below for detail)***

- After 3Q, BALL guided for a full-year tax rate of around 20% which would have required an approximate 21% rate for 4Q. The 4Q rate came in at 19.7% which was likely lower than what most analysts' models were expecting and could have added as much as 3 cps to EPS relative to expectations.

- We highlighted in the past how BALL increased the estimated useful lives for certain assets starting in 3Q which is adding about 6 cps to earnings per quarter compared to the old method. This non-operating earnings tailwind will continue for the next two quarters, at which point depreciation expense should begin to rise again as new assets come online.

Factoring on the Rise Again Despite Higher Costs

The following table shows the components of DSOs for the last eight quarters for both receivables on the balance sheet as well as those that have been factored and removed but are still outstanding:

	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Sales	$3,548	$3,951	$4,134	$3,716	$3,674	$3,553	$3,459	$3,125
Gross Trade Receivables	$1,373	$1,632	$1,731	$1,664	$1,304	$1,282	$1,462	$1,012
Unbilled Receivables	$746	$705	$831	$839	$727	$702	$649	$637
Allowance for Doubtful Accts	$12	$15	$16	$8	$9	$8	$9	$9
Net Trade + Unbilled	$2,107	$2,322	$2,546	$2,495	$2,022	$1,976	$2,102	$1,640
DSO	**54.6**	**54.1**	**56.0**	**60.4**	**50.6**	**51.2**	**55.3**	**47.2**
Outstanding Factored Receivables	$1,552	$1,362	$1,589	$1,108	$1,432	$1,270	$1,473	$1,252
Factored DSO	**40.2**	**31.7**	**35.0**	**26.8**	**35.9**	**32.9**	**38.8**	**36.1**
Adjusted Receivables	$3,659	$3,684	$4,135	$3,603	$3,454	$3,246	$3,575	$2,892
Adjusted DSO	94.9	85.8	91.0	87.3	86.5	84.1	94.1	83.3

Points to note:

- Gross trade receivables declined sequentially and roughly in line with sales. However, receivables that were factored and removed from the balance sheet yet remain outstanding rose both sequentially and YOY. This drove adjusted DSOs up by 8.5 days sequentially and 4.3 YOY. This could be an indication that revenue growth in the quarter benefitted from revenues made late in the period.

- Unbilled receivables showed a sequential acceleration in 4Q on declining sales. These amounts represent revenue that was recognized under long-term contracts that the company deemed it had earned but was not yet billed. It is typically a concern to see these balances outstrip revenue growth, but we suspect a disproportionate amount of unbilled receivables relate to the company's aerospace business where revenue continues to grow. This reduces our concern.

- BALL's operating cash flow is being compressed by excessive inventories that will not be converted to cash until 2023. However, the company continues to offset this by expanding the utilization of its receivables factoring facility. Outstanding factored receivables rose by $120 million in 2022 versus $64 million in 2021 implying a $60 million boost to cash flow growth from the expansion of factoring. However, rising rates make this more expensive and the company disclosed in the 10-K that the cost of its factoring program rose to $67 million in 2022 compared to $41 million in 2021 and $29 million in 2020.

Inventory Reserve Declining

The following table shows BALL's reserve for obsolete inventory as a percentage of gross receivables for the last sixteen quarters:

	12/31/2022	9/30/2022	6/30/2022	3/31/2022
Inventory Reserve	$91	$91	$96	$91
Gross Inventory	$2,270	$2,292	$2,569	$2,414
Reserve %	4.0%	4.0%	3.7%	3.8%

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Inventory Reserve	$90	$90	$94	$93
Gross Inventory	$1,885	$1,728	$1,584	$1,492
Reserve %	4.8%	5.2%	5.9%	6.2%

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Inventory Reserve	$93	$94	$97	$86
Gross Inventory	$1,446	$1,403	$1,485	$1,440
Reserve %	6.4%	6.7%	6.5%	6.0%

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Inventory Reserve	$82	$81	$79	$71
Gross Inventory	$1,356	$1,261	$1,262	$1,346
Reserve %	6.0%	6.4%	6.3%	5.3%

Points to note:

- BALL's inventories have been rising due to higher costs as well as an unplanned build from lower-than-expected revenue in the back half of the year. CFO Scott Morrison noted in the Q&A section of the conference call: “We still have too much inventory, and that's what we need to work off.” This higher-cost inventory should be sold in the first half of the year which will pressure margins.

- Despite the increase in inventory, the company’s reserve for obsolete inventory trended down in 2021. The reserve as a percentage of gross inventory now sits at 4% compared to its 6% level pre-Covid. We estimate it would take roughly 11 cps in charges to return the reserve to that level. If the company can sell these inventories in the first half of the year at expected prices this may not become an issue. However, delays from slower-than-expected demand could result in the company having to add to reserves and pressure profits more than anticipated.

Dentsply Sirona, Inc. (XRAY)
Earnings Quality Update

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

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

Summary

XRAY's adjusted 4Q22 of $0.46 beat forecasts by $0.13. As impressive as that sounds, investors should remember that 4Q21's EPS was $0.83 with some very questionable contributors. Also, 3Q22 adjusted EPS missed by $0.17 and caused XRAY to cut guidance and set up 4Q for an easy beat:

- Stock compensation was $12 million in 4Q22 vs -$6 in 4Q21 – a 6.7 cent headwind for 4Q22. Don't forget that stock compensation fell $8 million in 3Q and a quarterly expense figure of $19-$22 million is common. **One could argue the $12 million is still light $3-5 million or a 1-2 cent boost to EPS.**

- **R&D should have been budgeted at $45 million at least and came in $2 million light – that adds 1 cent to EPS.** We know 4Q21's R&D figure was nonsense due to the reclassification of prior SG&A, so we won't poke holes in a $6 million y/y decline.

- **Adjusted SG&A declined sequentially by $6 million – adding 2 cents to EPS.** SG&A is an area XRAY is touting that it will invest more in commissions, computer systems, and more people. Reducing the workforce will not impact the sales team and after 3Q results, said it was hiring more people in sales.

- **XRAY raised its tax rate forecast by 100bp after 3Q. The mid-point would have been 23.5% but it came in at 22.7% adding $4.5 million to 4Q results, or 2 cents.**

- **Depreciation was down another $1 million. Inventory reserves actually rose $6 million and bad debt reserves by $5 million. In total, that is 3.7 cents of headwind.**

- Warranty expense declined from $44 million in 2021 to $27 million in 2022, but it's not clear how much of that was in 4Q.

- **There is a new restructuring plan to save $200 million annually by cutting the workforce. That would be worth about 70 cents in EPS** and in a troubled 2022 XRAY just posted $2.09. Yet, the goal is only $3.00 in 2026 after four more years of stock repurchases which is already about 5 cents of EPS today vs 2017? The company posted EPS of $2.78 in 2016 and $2.66 in 2017. It was guiding to $3.05-$3.25 originally for 2022. This still does not look like a growth company.

Guidance looks very poor (or low-balled significantly) in our view. Flat sales of $3.85-$3.95 billion vs. the $3.92 billion it just posted and it will be backloaded with the second half stronger than first half. It is changing the profit metric to Adjusted EBITDA vs. Adjusted Operating Income. XRAY already ignores the amortization of purchased intangibles in operating income so all we need to do is add back depreciation. Guidance is for an EBITDA margin > 18%, but it just posted 19.8% and they are planning to cut costs. It shouldn't require a pole-vaulter to clear that bar.

EPS is expected at $1.80-$2.00 (with 30 cents from restructuring cost savings offsetting 20 cents of inflation) against the $2.09 it just reported. It is guiding to more selling and research costs too.

What to Watch

- **Inventory still looks bloated.** That does not bode well for gross margins or sales. DSI's are at record highs and XRAY just reported lower sales in every unit. On the call, they called out that they intend to eliminate many SKUs from inventory as part of the latest restructuring and that while they see a net low-single-digit price increase for 2023, the CFO also said, *"so obviously, we're discounting and actually reducing prices in some cases, China being one as an example and also other parts of the portfolio."*

DSIs	4Q	3Q	2Q	1Q
2022	134	134	129	120
2021	100	109	112	110
2020	91	115	176	143
2019	109	133	130	139
2018	102	136	124	144
2017	114	127	121	126

- HSIC's (a key customer) Inventory DSIs have been higher and even XRAY noted on the 3Q call that it started 2022 with inventories at the distributors too high. But, HSIC is even higher now. And, XRAY said to expect CAD/CAM inventory at dealers to increase in 1Q23:

HSIC	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Inventory	$1963	$1,818	$1,823	$1,871	$1,861	$1,784	$1,688	$1,626
DSI	76	77	80	77	72	72	74	73

- Likewise, PDCO's inventory and DSIs are also showing elevated levels and have not gone down during 2022 either:

PDCO	Jan 23	Oct 22	Jul22	Apr22	Jan22	Oct21	Jul21	Apr21
Inventory	$939	$877	$875	$786	$869	$830	$770	$737
DSI	68	62	66	55	63	57	56	53

- **Changing the metric to evaluate results is seldom a sign of improving earnings quality.** Instead of adjusted operating income which adds back acquired intangible amortization along with impairments and restructuring charges – XRAY is switching to adjusted EBITDA now. **Why the change? We think it is due to XRAY driving margin growth in the past by underinvesting in PP&E and watching depreciation decline becoming a tailwind for margins.** Two years ago, 4Q20 deprecation was $38 million. It just came in at $29 million for 4Q22. **That added almost a full point to adjusted operating margins.** New management sees depreciation about to increase – so why not pull it out of the metric to measure performance?

- Now, XRAY believes it needs more investment in the IT systems and the sales team. Plus, they see the need to further integrate the company:

*“**Key areas for investment include our global sales teams, our IT systems and in resources to ensure compliance. Many of these investments have already commenced**, and we have, for example, made great progress on the US sales force expansion. The vast majority are hired and were recently trained in our North America sales meeting.*

***Investments in our IT systems are necessary to modernize our landscape and further our enterprise integration. While these types of large-scale ERP endeavors are typically a multiyear journey requiring land investment**, they are critical to the business, operating efficiently and most importantly, being able to deliver for customers in an optimal way. We have commenced the process to understand this transformation over the past number of weeks.*

*Compliance is another critically important area. **Investing and compliance will support the remediation plan developed in 2022**.”*

- We have questions on this too. 1) How did SG&A decline in 4Q? That added 2 cents to EPS and it sounds like it will increase permanently going forward. 2) These companies merged in February 2016 – they haven’t fully integrated yet? 3) Restructuring charges since 2015 have been $890 million through multiple management teams and impairments have been $4.3 billion. Now another $165 million in restructuring is coming? 4) As we’ve noted before, the hefty impairments and the lack of sales growth here make us question if this company can actually grow. Sales have been just under $4 billion since before the merger in 2016 and guidance is again for sales of just under $4 billion.

- **Where is the top-line growth?** This is supposed to be a long-term growth story with population growth, emerging markets growth, aging populations needing more dental care, and a surge in aligners. Here are the growth rates for the last six fourth quarters which show the growth since the merger:

	4Q22	4Q21	4Q20	4Q19	4Q18	4Q17
Sales	$983	$1,103	$1,082	$1,112	$1,060	$1,091
Y/Y Change	-10.9%	0.6%	-2.6%	4.9%	-2.9%	9.5%
Org./Internal Chg.	2.6%	1.8%	-3.3%	8.4%	-0.1%	5.3%

There are several reasons why this is worse than it looks and investors should also keep in mind:

- In the 4Q17 quarter internal growth was 5.3% - however – management called out $21 million specifically as inventory build. Taking that out, the internal growth was only 3.2%. Also, everything collapsed in 2018 because of hefty channel stuffing.

- The 4Q19 was up 8.4% - but even XRAY said much of this was rolling out new products into the channel. It did not necessarily mean sell-through to dentists and consumers. And it certainly did not last.

- 4Q20 was obviously Covid times, but dentists had reopened by then and were completing scheduled and delayed appointments – XRAY still couldn't outsell the channel stocking of 2019.

- **In 2020, XRAY changed from Internal Growth to Organic Growth. Both exclude M&A, divestitures, and FX. However, Internal growth also excluded the price impact of precious metals in products.** XRAY has hedges in place that eliminate the impact of precious metals in inventory and they effectively record the precious metals in revenue and cost when a sale is made. Organic growth does NOT exclude this anymore. And, the prices of precious metals in question are basically up (Gold, Silver, Platinum are all up from December 2019 and Paladium was down from 2019 levels in 2022). **This should have effectively been a price hike for XRAY that helped sales growth in years 2020-2022.**

- Finally, there was a price hike in 4Q21 and there were two more that helped 4Q22. They are planning another price hike in 2023 too. XRAY never quantifies price vs. volume – but if organic growth is 2% with three price hikes – volume stinks. And XRAY is going to try to work down inventories into a channel with already high inventories.

International Business Machines Corporation (IBM) Earnings Quality Update part 2

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

We have IBM's annual report and can look more completely at the 4Q22 earnings of $3.60 that missed by 1 cent. We think the miss is actually much worse than first glance would indicate:

- **Depreciation dropped again and added $73 million y/y or 6.8 cents to EPS.**

IBM	4Q22	3Q22	2Q22	1Q22	4Q21
Depreciation	$570	$586	$620	$631	$643

- IBM announced this tailwind will continue in 2023 as it changed the depreciation lives of existing server and network equipment from 4 years to 5 and new equipment from 5 years to 6. This will add $200+ million to earnings in 2023 or about 4.5-5.0 cents more per quarter.

- **Workforce rebalancing came lower than expected at only $4 million.** Historically, this is lumpy but **can average $200-$500 million per year.** Much of it relates to integrating new acquisitions – which is an area where IBM continues to focus with 30 deals in the last 3 years. It came in at only $50 for all of 2022 still benefiting after a sizeable charge in 4Q20. We continue to expect this to be a much more sizeable and recurring charge for IBM results going forward. **$50 million per quarter is 4.5 cents in EPS headwind.**

- **Share compensation fell $15 million adding almost 2 cents to 4Q22.**

- **Cuts in advertising added $32 million or 3.0 cents to EPS in 4Q22.**

- **Extended warranty new deferrals were -$3 million vs $62 million in 4Q21. That added as much as 6 cents to EPS for 4Q.**

- **Bad debt expense rose $30 million for a 3.0 cent headwind**

Assuming just these items as being less than quality sources of earnings and treating workforce rebalancing as a zero impact, we think IBM had 15 cents in low-quality sources of EPS in a quarter where it already missed by 1 cent.

Plus, we know R&D was down in dollar terms and percentage of sales adding 2 cents to almost 5 cents. SG&A without advertising, workforce rebalancing, amortization of intangibles, stock compensation, or bad debt was down $117 million in dollars or as much as 11 cents. We'll point those out solely to ask why isn't IBM seeing wage inflation.

Guidance is for about 8 cents of headwind from lower pension income in 2023 against nearly 20 cents in tailwind from lower depreciation. We think workforce rebalancing could be a wildcard that approaches another 15-20 cents in headwind the market is not expecting along with higher R&D.

Mohawk Industries, Inc. (MHK)
Earnings Quality Update

We are mainlining our earnings quality rating of MHK of 2- (Weak)

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

Summary

MHK reported 4Q non-GAAP EPS of $1.32 for 4Q22. This was 3 cps ahead of what the Street was expecting. However, on January 16 (after the close of the quarter), the company lowered its 4Q guidance from a range of $1.40-$1.50 to $1.27-$1.31. We found it interesting that MHK's 4Q adjusted effective tax rate was 12.6% which was down from 17.9% in the third quarter and 18.9% a year ago. In the third-quarter conference call, management forecasted a 20% tax rate for the fourth quarter. There was no update to the tax rate outlook in the January 16 revision press release and we saw no public mention of any reduction to the tax rate outlook. It appears to us that analysts were not expecting the fourth-quarter rate to be nearly that low. The lower-than-forecast rate added 11 cps to EPS.

- **Trade receivables DSOs rose to 55.8 versus 53.7 in the year-ago period**. Management noted in the call that this was "due in part to customer and channel mix." We also note that "other receivables" rose to 7.5 days of sales from 3.8 days in the year-ago quarter. This should be monitored in the next quarter for signs of the company extending more generous payment terms to drive sales. ***(See detail below)***

- **The warranty accrual as a percentage of revenue rose sequentially from 1.3% to 1.4% but remains well below normal levels.** We estimate that it would cost 6 cps to increase the reserve percentage to the year-ago level, but it would take 18 cps to increase the reserve percentage to its pre-Covid level of 2%. ***(See detail below)***

- **Inventory DSIs rose to 123.7 from 106.6 in the previous year.** Management made inventory reduction a priority in the fourth quarter due to moderating demand and the expectation that costs will begin to ease in the first half of 2023. It limited production in the fourth quarter, which decreased fixed cost absorption and pressured margins. The high-cost inventories are expected to work their way through the income statement in the first quarter which will continue to pressure profitability. Management hopes to rebuild inventory at a lower cost as the year moves on.

- Lower stock compensation expense added 1.6 cps to EPS.

- **The allowance for discounts, claims, and doubtful accounts as a percentage of gross receivables rose to 4.3% from 3.8% in the previous quarter.** We have highlighted in recent reviews how the company has been reducing its receivables allowance since it was raised during Covid but that the level has fallen below the pre-Covid norm. The company doesn't provide provision expense, but we estimate the sequential increase in the reserve percentage was an 11 cps headwind to EPS. We are less concerned about this item moving forward other than the possibility that a slowing economy could lead to the company having to continue increasing reserves which is not a company-specific problem.

- **MHK announced it settled its shareholder lawsuit related to the alleged manipulation of receivables and inventory balances for $60 million.** It continues to state that the case is without merit and it is settling to avoid the distraction. However, the related US Attorney and SEC investigations into the matter are still ongoing. Our stance has been that while inventories were definitely inflated, the company was somewhat forthcoming at the time that it was carrying excess inventory which it later worked down. If the allegations of excessive levels of unusable inventory on hand were true, it would have likely required a sizeable writedown to resolve which never occurred.

Receivable DSOs Rising

The following table shows the calculation of trade receivables and other receivable DSOs for the last twelve quarters:

	12/31/2022	10/01/2022	7/2/2022	4/2/2022	12/31/2021	10/2/2021	7/3/2021	4/3/2021
Revenue	$2,650.675	$2,917.539	$3,153.188	$3,015.663	$2,760.737	$2,817.017	$2,953.833	$2,669.026
Net Trade Receivables	$1,625.351	$1,827.737	$1,929.705	$1,873.806	$1,648.435	$1,742.536	$1,779.623	$1,629.647
Net Trade Receivables DSOs	55.8	57.0	55.7	57.2	53.7	56.3	54.8	56.8
Other Receivables	$219.355	$148.283	$132.776	$111.527	$117.823	$108.505	$101.882	$78.371
Other Receivables DSOs	7.5	4.6	3.8	3.4	3.8	3.5	3.1	2.7
Net Trade + Other DSOs	63.3	61.6	59.5	60.6	57.6	59.8	58.0	59.5

Points to note:

- Net trade receivable DSOs rose to 55.8 from 53.7 a year ago. The overall level in the mid-50 range is not alarmingly high.

- However, other receivables showed an unusual spike in the quarter as DSOs rose to 7.5 from 3.5 a year ago and 4.6 in the previous quarter. We are uncertain of the exact composition of other receivables but we do know that it is separate from tax receivables which are disclosed separately.

- Management noted on the conference call that "receivables for the quarter ended at $1.9 billion with the DSO at 60 days versus 56 days in the prior year, ***due in part to customer and channel mix***." The $1.9 billion figure includes trade, other, and tax receivables. Note that we calculate DSO using ending receivables and quarterly sales which likely accounts for the difference between our DSO figures and management's. Regardless, the magnitude of the DSO increase is similar. Given that the bulk of the total DSO increase is coming from other receivables, we believe that the increase in other receivables is also related to the change in customer and channel mix that management referenced in the call.

- Such a large sequential increase in receivables in a quarter with declining sales is worth noting and could represent sales being pulled into the fourth quarter at the expense of the first. Receivables should be monitored closely in the next quarter.

Warranty Reserve Remains Depressed

The following table shows the warranty accruals as a percentage of sales for the last sixteen quarters:

	12/31/2022	10/01/2022	7/2/2022	4/2/2022
Revenue	$2,650.675	$2,917.539	$3,153.188	$3,015.663
Warranty Reserve	$38.425	$39.190	$40.942	$41.693
Warranty Reserve % of Sales	1.4%	1.3%	1.3%	1.4%

	12/31/2021	10/2/2021	7/3/2021	4/3/2021
Revenue	$2,760.737	$2,817.017	$2,953.833	$2,669.026
Warranty Reserve	$45.215	$46.346	$54.702	$55.024
Warranty Reserve % of Sales	1.6%	1.6%	1.9%	2.1%

	12/31/2020	9/26/2020	6/27/2020	3/28/2020
Revenue	$2,641.764	$2,574.870	$2,049.800	$2,285.763
Warranty Reserve	$54.692	$53.520	$53.769	$51.983
Warranty Reserve % of Sales	2.1%	2.1%	2.6%	2.3%

	12/31/2019	9/28/2019	6/29/2019	3/30/2019
Revenue	$2,424.512	$2,519.185	$2,584.485	$2,442.490
Warranty Reserve	$49.184	$46.984	$47.873	$46.129
Warranty Reserve % of Sales	2.0%	1.9%	1.9%	1.9%

Points to note:

- While the reserve percentage rose sequentially for the first time in two years, it remains low relative to historical trends.

- It would cost 6 cps to increase the reserve percentage to the year-ago level, but it would take 18 cps to increase the reserve percentage to its pre-Covid level to 2%.

Patterson Companies (PDCO)
Earnings Quality Update

We are raising our earnings quality rating of PDCO to 3+ (Minor Concern) from 2+ (Weak).

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

Summary

PDCO posted $0.62 in adjusted EPS for fiscal 3Q23 (ending in January). That beat forecasts by 1-cent.

- Stock compensation fell from $4.9 million to just under $3 million adding 1.5 cents to EPS.

- The effective tax rate dropped 220 bps and added 1.8 cents to EPS. Even management doesn't expect the lower tax rate to last.

- We are still amazed that management continues to blame poor sales on pricing pressure from protective equipment. This started years ago and they have written it down and even given it away at times. But, they still expect it to be a headwind for several more quarters.

PDCO cut the top-end of guidance by 5 cents for the fiscal year ending in April following the beat. We boosted the earnings quality rating simply because we see fewer adjustments to non-GAAP earnings of late and the two non-sustainable items above are fairly minor. We do think investors should monitor inventory levels as a potential issue for sales and margins. Also, rising interest rates are starting to create larger lumpy surprises on earnings when PDCO sells receivables and financing contracts.

What to Watch

- **Inventory levels are rising as sales growth stalls.** Sales have been flat to down y/y the last three quarters in a row. There is some inflation, but PDCO is touting its increased use of private-label products that are priced below similar items. Plus, PDCO works to gain volume discounts from suppliers to lower inventory costs too:

From the earnings call- *"We remain focused on driving operating margin expansion through our efforts to improve gross margin with pricing and cost execution, working more closely with strategic vendors who reward us for our sales performance, driving improved mix, as well as exercising expense discipline and leveraging our cost structure as we grow the top line."*

PDCO	Jan 23	Oct 22	Jul22	Apr22	Jan22	Oct21	Jul21	Apr21
Inventory	$939	$877	$875	$786	$869	$830	$770	$737
DSI	68	62	66	55	63	57	56	53

We know that DSI's have been about 70 in the past. We also know that some of those 50s were when PDCO was writing off PPE inventory. As much as they fall back on that PPE crutch, PDCO is not talking about it with as high a level of concern now. We would watch this for potential gross margin pressure in the near term, but would not rank this as the largest red flag ever at 68 days.

- Selling receivables is starting to have larger impacts on EPS with rising interest rates. When Receivables are sold, PDCO books a gain or loss into operating costs. Normally this is less than $1 million per quarter. It's been above $3 million the last two periods and is costing PDCO about 2.5 cents per quarter.

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Adj. EPS	$0.62	$0.63	$0.32	$0.71	$0.55	$0.58	$0.43	$0.38	$0.58
Gain/Loss on A/R	-$3.254	-$3.211	-$1.435	-$9.690	-$0.663	-$0.894	-$0.721	-$1.263	$0.926
EPS Impact	-$0.026	-$0.025	-$0.011	-$0.076	-$0.005	-$0.007	-$0.006	-$0.010	$0.008

- Selling finance contracts that PDCO uses for equipment purchases by customers is also creating some minor issues for EPS. These contracts are sold to banks as well and have a longer life than the accounts receivable. PDCO marks the value of the outstanding contracts and residuals to market each quarter. The gain/loss is netted against sales. So without the gain/loss, the sales figure and the operating income figure would change by the same amount. However, the math makes the operating margin figure move:

($ in mm)	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Sales	$1,600.9	$1,626.2	$1,523.3	$1,638.8	$1,596.7	$1,649.2	$1,614.9	$1,561.8	$1,551.3
Adj. Op. Income	$85.4	$69.4	$44.2	$82.2	$70.1	$74.3	$57.6	$47.7	$70.9
Adj. Op. Margin	5.33%	4.27%	2.90%	5.02%	4.39%	4.51%	3.57%	3.05%	4.57%
Gain/Loss Fin. Conts.	$2.417	-$8.456	$0.988	-$9.946	-$5.143	-$3.363	$0.073	-$1.836	-$1.484
Sales w/o Gain/Loss	$1,598.4	$1,634.7	$1,522.3	$1,648.7	$1,601.8	$1,652.5	$1,614.8	$1,563.6	$1,552.8
Op Inc. w/o G/L	$82.987	$77.860	$43.207	$92.189	$75.228	$77.700	$57.515	$49.535	$72.403
Op Margin w/o G/L	5.19%	4.76%	2.84%	5.59%	4.70%	4.70%	3.56%	3.17%	4.66%

Gains help sales, operating income, and margins. Losses do the reverse. In the last quarter, the mark was a gain and helped margins rise by 14bp. Our concern is there are more losses than gains and as interest rates have been rising, the losses have become much larger even though they remain lumpy. In 2Q23, PDCO lost 49bp on margin due to the $8.5 million loss and in 4Q22, it lost 57bp on margin due to the $9.9 million loss. PDCO is touting its margin improvements, but this may be a headwind that is difficult to overcome consistently.

- These gains and losses are partially offset by interest rate hedges. But, these are recorded below the operating income line. They normally have the expected inverse relationship but do not always match in dollar terms and as the numbers are becoming larger this also has EPS impacts:

($ in mm)	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Gain/Loss Fin. Conts.	$2.417	-$8.456	$0.988	-$9.946	-$5.143	-$3.363	$0.073	-$1.836	-$1.484
Hedge Gain/Loss	-$1.849	$13.072	-$1.948	$10.030	$3.688	$3.304	-$1.187	$1.786	$0.145
Net Impact	$0.568	$4.616	-$0.960	$0.084	-$1.455	-$0.059	-$1.114	-$0.050	-$1.339
Adj. EPS	$0.62	$0.63	$0.32	$0.71	$0.55	$0.58	$0.43	$0.38	$0.58
EPS impact G/L	$0.004	$0.036	-$0.008	$0.001	-$0.011	$0.000	-$0.009	$0.000	-$0.011

Normally this program nets out to 0-1 cent +/- on EPS. We see that in 2Q23 it was a positive 3.6 cents.

- We would also be concerned that this company is normally viewed as being a dental distributor and even management gives the same bullish case on conference calls that we hear from Dentsply-Sirona. People will spend more to take care of their teeth, the population is growing, aging populations need more dental care…

The basic issue we have is PDCO has two businesses – the dental unit is less than 40% of sales and it's not growing while the animal health unit is more than 60% of sales and it does grow. The dental unit has a 10% margin but the animal health one is less than 3%. There is simply a limit to how much the animal health margins can improve and if that business grows at a faster rate, it should also pressure the company's overall margins.

Starwood Property Trust (STWD)
Earnings Quality Update

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

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

Summary

STWD's 4Q22 distributable earnings (DE) of 50 cents met forecasts. There were some headwinds that should mitigate:

- **Real Estate Owned where STWD has taken ownership and will repurpose or sell the property cost DE about 5 cents in the 4Q** as it is not earning cash rent/interest income at this time. There is an agreement to sell one property in Houston, the 21 NYC condos are starting to sell, and there are discussions to sell or partner in repurposing an LA property.

- **STWD exited its ownership in a residential mortgage originator. That resulted in an $11 million recognized loss for 4Q up from $5 million in 3Q. This was 3.4 cents of headwind for 4Q22.**

- **Few follow this on a GAAP basis, but CECL (Current Expected Credit Losses Model) required by GAAP boosted loss reserves by 8 cents per share in 4Q22.** This does not impact DE. STWD does not see an issue as the concerns in the market are on office space in New York and San Francisco where STWD has almost no exposure and it cut its total exposure in office space from 38% to 23% of the portfolio. It also has never taken a loss on any property it repossessed in its history.

- Also impacting GAAP, diluted share count of 317.6 million includes 9.6 million shares related to convertible debt. STWD intends to repay that $250 million in debt in April and the dilution impact should vanish from the GAAP share count.

STWD continues to trade below book value of $21.70 and it reiterated again that without doing anything, the current portfolio covers the dividend. If anything, rising rates should boost DE and dividend coverage. With 99% floating-rate securities in the commercial lending unit, another

50bp of interest rate increases adds 1.5 cents to DE per quarter and 100bp another 3 cents per quarter.

What to Watch

- Fortress balance sheet continues to be the case here. 88% of STWD's borrowing does not have triggers based on collateral values changing due to market spreads. It has considerable assets in securitizations and CLOs that do not require unrealized marks to book value. It is generating more than enough cash flow to pay its dividend and had $8 billion in liquidity plus $3.9 billion in unencumbered assets it could raise cash on. The $8 billion is already removing the $250 million convertible bond payment in April.

- STWD even discussed the safety of its loans amid higher interest rates. First, it has loan-to-values that average 60%. Second, 33% is in multi-family and only 23% in office. Rents remain strong in multifamily and total supply growth may be slowing with higher interest rates. Barry Sternlicht stated on the earnings call:

> *"[**Even in multifamily] the ability to get financing construction loans is gone. And you already have a 1.7 million housing shortage.** So short and long-term, you're going to see rents – they are actually – headline rents are going down, but in-place rents are going up because it's the gap in these buildings in our portfolio alone on the loan book, **Jeff tells me our rents have increased more than 20% since we started making those loans**. So that they will hit their stabilized yields, we think, fairly quickly.*
>
> *And I would be delighted and sad, but delighted if we take the multis back because the long game for multi is excellent. There is no ChatGPT issue going to attack the residential sector. **And because housing single-family home supply is going down, single-family construction costs are going up, interest rates and the cost of owning of home are going up, it makes rental homes that much more attractive."***

For Office properties, it's down from 38% to 23% of the portfolio with little to no exposure for NYC and San Francisco, and 80% of it is A-Class in the US and 89% in International. Demand is still there for A-Class with rents going up. Plus the borrowers paying STWD the rising interest rates have caps in place. Barry Sternlicht again:

"You can't really tell looking at [REIT] companies in private or public today what's going on exactly in these companies because many of us have floating rate debt, which is fantastic. ***<u>Our earnings are going up with floating rate debt. Our borrowers, most of whom have caps in place and can pay us until the loan maturity."</u>***

<u>"Everywhere but the United States offices are leasing</u>*, I just – we have some investments in Europe, particularly in Germany. The vacancy rate in Berlin is 4%; in Munich, it's less than that.* ***<u>Rents are up</u>****; in Munich, 12%. If you look at Asia, the Middle East, Korea, Japan, Australia, people have gone back to the office. It is a U.S. phenomenon probably led by the tech sector which has created this unusual situation in U.S. office.* ***<u>And in the U.S., you have a tale of two cities. You have newer buildings and, A, buildings leasing and everything else emptying. And it's almost a one-for-one switch. So if you are in the A sector, you're doing okay."</u>***

"We have 10 buildings to choose from ***<u>A quality in San Francisco, and they are not lowering their rents,</u>*** *I was in credulous. I mean I can't believe it.* ***<u>It's like a 40% vacant market, and we have to pay more</u>*** *– much more than we're paying today to be in the best buildings, there is very good demand for high-quality assets.* ***<u>And there is no demand at all for other assets. And over time, these buildings will be converted to other uses."</u>***

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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