BEHIND THE NUMBERS
Quality of Earnings Analysis
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# Behind the Numbers

*Companies in this Issue*



# Air Lease Corporation (AL)
# Earnings Quality Update

*We are maintaining our earnings quality coverage 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 2Q23 adjusted EPS of $1.58 beat forecasts by 19 cents. We still view believe AL should trade at or above its book value which has now risen to $54 and we believe book value is still understated.

- Aircraft sales returned in 2Q, with eight planes being sold and generating $45 million in gains. This was worth 33 cents of higher book value, which we have noted is understated because the planes on the balance sheet are being valued below fair market value due to depreciation in a market of high demand. These sales were expected to occur during 2023 and the gains on an adjusted basis were worth 40 cents in non-GAAP EPS.

- Overhaul revenues net of amortization also rose to $10.2 million from $2.4 million in 2Q23, which was worth 7 cents in adjusted EPS.

- SG&A rose again as was expected due to more leases being in place, the aircraft sales, and higher insurance premiums. However, with AL seeing more of its second business aircraft trading returning, the SG&A cost leveraged on the higher revenue and declined by 10bp as a percentage of sales.

- The spread between BBB and B-rated debt has normalized a bit more to 260bp, which gives AL ample spread to make money in leasing new planes. Also, its current cost of funds is still only 3.49% vs. the current BBB cost of 5.88% - giving AL another 239bp of positive spread to work with.

- There were no updates on the insurance claims for the Russian planes that were nationalized, but we still believe there is a potential to recover about $5 per share in book value there.

- We still see the recent gains that have been booked as evidence that depreciation is lowering the value of planes below fair market value. Every 1% that fair market value of planes exceeds the depreciated value is worth about $2 per share in book value.

- AL did report again that it has routes to compensation from the aircraft and engine manufacturers for the excessive delays in receiving their orders. Also, lease rates are rising amid higher interest rates and are not set until the plane is delivered, so delayed deliveries should also result in higher leasing revenue as planes do arrive.

# Ball Corporation (BALL)
# Earnings Quality Update

*We are upgrading our earnings quality rating to 3+ (Minor Concern) and leaving it on our On-Deck Value list*

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

## Summary

BALL reported in-line EPS for the 6/23 quarter while revenue fell about $200 million shy of the outlook. The adjusted effective tax rate of 18.4% was likely about half a point below what analysts were modeling without which, the company would have missed. The disappointment in revenues was a result of disruption from *Bud Light* sales as BUD accounts for over 10% of the company's total sales. Regardless, the company is still talking about hitting the low end of its long-term 10%-15% adjusted EPS growth rate in 2023 as volume declines are offset by cost savings and PPI pass-through provisions which began to take effect in earnest on July 1. The free cash flow forecast also remained intact at $750 million for 2023.

Items of note in the quarter included:

- DSOs adjusted for factoring fell to 90.1, down from 91.0 a year ago and 94.1 in the previous quarter. This brings to an end a string of increases which we believe improves the quality of recognized revenue in the quarter. ***(See below for details)***

- However, we are still amazed that the company's receivables factoring program continues to grow as outstanding factored receivables jumped by $171 million versus the previous quarter providing a boost to cash flow growth in the period. ***(See below for details)***

- Note that the company also disclosed in the 10-Q that client payables under third-party financing programs fell to $488 million (14% of payables) from $680 million (19% of payables) in the previous quarter. Thus it appears that the benefit from increased factoring was roughly offset by the decline in payables factoring. As such, we are not overly concerned with the quality of cash flow growth in the period.

- Lower depreciation expense from the change in estimated lives added another 6 cps to the quarter's EPS. This was anticipated by analysts so it does not impact the quality of the beat. However, this is a low-quality source of growth, and the change anniversaried on July 1 so the tailwind is gone moving forward.

- The disruption in the beer market is expected to normalize by the beginning of 2024. Meanwhile, soft drink volumes also remain weak as companies are still grappling with low volumes in the wake of price hikes. However, slowdowns in pricing and increasing promotional pushes are expected to help volumes begin to recover later this year. These conditions normalizing as inflation recovery provisions began to kick in in July should provide fertile ground for growth.

- As we have discussed in past reviews, inventories are slowly declining as the company continued to throttle production after last year's overbuild. This along with the wind down in the capital spending program will result in free cash flow growth to enable deleveraging to begin. Active talk of selling the Aerospace unit began during the second quarter with rumors of possible bids between $5 billion and $8 billion flying around. $5 billion would represent about 2.5 times revenue which seems quite reasonable. This would allow the company to take a huge chunk out of its $11 billion debt and utilize its growing cash flow for repurchases and possibly dividends.

- A quick note about our earnings quality score- While we have BALL on our On Deck Value list, we are leaving the earnings quality score in the Minor Concern level to reflect that we are not big fans of the aggressive use of factoring or the extension of depreciable lives. If these issues continue to improve we will likely upgrade to a 4 (Acceptable) in the future. The On Deck Value designation stems from the setup for solid EPS growth and rapid cash flow growth coupled with negative sentiment on the Street from focusing on what we believe are temporary problems.

## DSOs Improved- but Factoring Jumped Again

The increase in DSOs adjusted for factoring came to an end in the 6/23 quarter as shown in the following table:

| | 6/30/2023 | 3/31/2023 | 12/31/2022 | 9/30/2022 | 6/30/2022 | 3/31/2022 | 12/31/2021 |
|---|---|---|---|---|---|---|---|
| Sales | $3,566 | $3,489 | $3,548 | $3,951 | $4,134 | $3,716 | $3,674 |
| Gross Trade Receivables | $1,041 | $1,260 | $1,373 | $1,632 | $1,731 | $1,664 | $1,304 |
| Unbilled Receivables | $793 | $824 | $746 | $705 | $831 | $839 | $727 |
| Allowance for Doubtful Accounts | $11 | $12 | $12 | $15 | $16 | $8 | $9 |
| Net Trade + Unbilled | $1,823 | $2,072 | $2,107 | $2,322 | $2,546 | $2,495 | $2,022 |
| DSO | 46.0 | 53.4 | 54.6 | 54.1 | 56.0 | 60.4 | 50.6 |
| | | | | | | | |
| Outstanding Factored Receivables | $1,748 | $1,577 | $1,552 | $1,362 | $1,589 | $1,108 | $1,432 |
| **Factored DSO** | **44.1** | **40.7** | **40.2** | **31.7** | **35.0** | **26.8** | **35.9** |
| Adjusted Receivables | $3,571 | $3,649 | $3,659 | $3,684 | $4,135 | $3,603 | $3,454 |
| Adjusted DSO | 90.1 | 94.1 | 94.9 | 85.8 | 91.0 | 87.3 | 86.5 |

***Points to note:***

- DSOs adjusted for factoring fell to 90.1, down from 91.0 a year ago and 94.1 in the previous quarter. This brings to an end a string of increases which we believe improves the quality of recognized revenue in the quarter.

- However, we are still amazed that the company's receivables factoring program continues to grow as outstanding factored receivables jumped by $171 million versus the previous quarter providing a boost to cash flow growth in the period.

- Note that the company also disclosed in the 10-Q that client payables under third-party financing programs fell to $488 million (14% of payables) from $680 million (19% of payables) in the previous quarter. Thus it appears that the benefit from increased factoring was roughly offset by the decline in payables factoring. As such, we are not overly concerned with the quality of cash flow growth in the period.

# Cloudflare, Inc.
# (NET) Earnings Quality Update

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

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

## Summary

NET's 2Q23 adjusted EPS of $0.10 beat by 3 cents and the company reported $20 million in free cash flow. After 1Q's 5-cent beat, NET cut revenue guidance by $50 million and boosted EPS guidance based on a lower tax rate. After 2Q's 3-cent beat, NET raised revenue guidance by a mere $3 million and added only 2 cents to its EPS forecasts for the year. Clearly, the outlook for full-year growth has eroded since the beginning of the year.

We see too many areas where NET has made earnings by certain items coming in much better than recent guidance but then the guidance for the full year is not changed. We can point to several situations like that which can explain away the entire second-quarter beat:

- NET came into 2023 with guidance for a 36% tax rate. In 1Q, the rate was 12.4% which added 2 cents to EPS. It lowered guidance for the year to 9%. In 2Q, the rate came in at 3.9% - that added 0.5 cents to EPS in 2Q. Now the guide is 11% in 3Q and still 9% for the year.

- NET's non-GAAP operating margin has increased, although it was down slightly sequentially in 2Q. However, this margin increase is due to a rise in stock compensation which NET adds back to non-GAAP margins:

| | 2Q23 | 1Q23 | 4Q22 | 3Q22 | 2Q22 | 1Q22 | 4Q21 | 3Q21 | 2Q21 |
|---|---|---|---|---|---|---|---|---|---|
| Sales | $308.5 | $290.2 | $274.7 | $253.9 | $234.5 | $212.2 | $193.6 | $172.3 | $152.4 |
| Stock Comp | $71.6 | $61.8 | $62.6 | $55.9 | $57.5 | $41.8 | $42.1 | $28.0 | $24.1 |
| % of Sales | 23.2% | 21.3% | 22.8% | 22.0% | 24.5% | 19.7% | 21.7% | 16.3% | 15.8% |
| | | | | | | | | | |
| Headcount | 3,393 | 3,394 | 3,217 | 3,181 | 3,063 | 2,751 | 2,439 | 2,240 | 2,050 |
| Stk/employee | $21.1 | $18.2 | $19.5 | $17.6 | $18.8 | $15.2 | $17.3 | $12.5 | $11.8 |
| | | | | | | | | | |
| Adj Op Marg | 6.6% | 6.7% | 6.1% | 5.8% | -0.4% | 2.3% | 1.2% | 1.3% | -2.6% |

- 2Q23 margins had 190bp of additional stock compensation added back, which was 1.6 cents in non-GAAP EPS.

- 2Q23 also saw cash R&D decline again as a percentage of sales. Selling & Marketing declined too, but is showing some higher spending which NET has called out:

| | 2Q23 | 1Q23 | 4Q22 | 3Q22 | 2Q22 | 1Q22 |
|---|---|---|---|---|---|---|
| Cash R&D | $53.1 | $51.3 | $49.4 | $46.4 | $46.2 | $40.3 |
| % of sales | 17.2% | 17.7% | 18.0% | 18.3% | 19.7% | 19.0% |
| Cash Sales/Mrk | $125.4 | $120.6 | $113.0 | $103.5 | $103.9 | $89.7 |
| % of sales | 40.6% | 41.5% | 41.1% | 40.8% | 44.3% | 42.3% |

The problem we have with R&D at these levels is NET has said that as it achieves higher sales growth to leverage expenses, adjusted R&D is still expected to be 18%-20% of sales. We know sales are impaired for both 1Q23 and 2Q23 – yet the cash R&D came in below long-term forecast levels. 100bp of additional R&D is 0.9 cents of quarterly EPS. We also want to point out that 1Q23 sales were back-loaded and receivables rose too – causing NET to cut sales forecasts for 2023. R&D is supposed to leverage with rising sales, but now it's below long-term forecasts on weaker sales.

- Long-term guidance on gross margin is also expected to be closer to 74%-75%. This was 77.7% in 2Q23 and 77.8% in 1Q23. This is about 1.7 cents of EPS and is adding 200bp to the non-GAAP operating margin above too.

- Higher rates drove interest income to 4.2 cents of 2Q23 adjusted EPS. This compares to virtually nothing a year ago. That is real income but is also the entire beat. It also represents 40% of reported income.

- We see a headwind for NET in bad debt expense which rose by $3.4 million y/y in 2Q which cost NET 1.0 cent in EPS.

There are signs that sales growth should strengthen, even though total sales guidance for 2023 was only raised by $3 million after 2Q results. Several signs such as receivables, deferred revenue, and contract acquisition costs all point to rising sales:

| | 2Q23 | 1Q23 | 4Q22 | 3Q22 | 2Q22 |
|---|---|---|---|---|---|
| Sales | $308.50 | $290.20 | $274.70 | $253.90 | $234.50 |
| A/R | $177.90 | $179.70 | $148.60 | $126.90 | $122.10 |
| Def. Rev | $286.80 | $238.80 | $218.60 | $171.40 | $155.80 |
| | | | | | |
| A/R DSO | 52.5 | 55.8 | 49.8 | 46 | 47.4 |
| DefRev DSO | 84.6 | 74.1 | 73.2 | 62.1 | 60.5 |
| Retention % | 115% | 117% | 122% | 124% | 126% |

  - The higher receivables may hinder some sales growth for the rest of 2023, but they already turned down from the back-loaded 1Q.

  - Deferred revenue jumped significantly which bakes in some future revenue. NET is now showing nearly a full quarter's worth of sales in deferred revenue.

  - The company also signed more contracts in 2Q23. The spread between new capitalized acquisition costs and amortization of past costs widened. This was a concern we had after 1Q, when it declined, but 2Q showed a solid recovery and explains some margin leverage as the amortization level is seeing slower growth:

| | 2Q23 | 1Q23 | 4Q22 | 3Q22 | 2Q22 |
|---|---|---|---|---|---|
| Sales Aq cost | ($24.0) | ($19.4) | ($19.0) | ($18.4) | ($15.0) |
| amortization | $14.9 | $14.1 | $13.1 | $11.8 | $10.6 |
| Net | ($9.1) | ($5.3) | ($5.9) | ($6.6) | ($4.4) |

- The problem is NET picked up so much in earnings in the first two quarters from margin expansion which didn't look sustainable. NET seems to be confirming this by forecasting sales rising to $330 million for 3Q and $355 million for 4Q – but it expects flat-to-lower EPS on the higher sales – 10 cents for 3Q and 9 cents for 4Q.

- Free cash flow still does not impress us. NET is spending the same or lower on capital spending y/y in 2023 and is flat on capitalized software too. Plus, stock compensation still exceeds free cash flow. Free cash flow was $20 million in 2Q23. If stock compensation had been 20% of sales – free cash flow falls to $10 million. Receivables were only a $2.6 million headwind in 2Q vs. a headwind of $32.8 million in 1Q and deferred revenue added another $12.7 million to free cash flow in 2Q23.

# Post Holdings, Inc. (POST)
# Earnings Quality Update

*We are maintaining our earnings quality coverage of POST at 2- (Weak).*

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

## Summary

Adjusted EPS of $1.52 beat forecasts by 59 cents. We again do not consider this beat real or sustainable. Raw material cost inflation is stalling rapidly and POST is still taking price hikes far in excess of what is necessary. However, the total pricing gain dropped materially in the quarter but costs simply fell even faster. We still believe this will catch up with POST and it will see pricing drop faster going forward:

- Lower freight costs are now helping earnings. Segments like Foodservice where pricing was up about $34 million with raw materials falling by more than $6 million and freight declining by $10 million look unsustainable.

| | 3Q23 | 2Q23 | 1Q23 | 4Q22 | 3Q22 | 2Q22 | 1Q22 |
|---|---|---|---|---|---|---|---|
| Pricing | $117.1 | $229.8 | $231.2 | $234.8 | $190.7 | $85.1 | $89.5 |
| Raw Materials | $35.5 | $160.4 | $142.7 | $111.7 | $123.7 | $51.6 | $46.5 |
| Manufacturing | $26.1 | $23.1 | $14.4 | $20.6 | $27.1 | $23.7 | $23.4 |
| Freight | -23.4 | -$21.0 | $0.0 | $19.5 | $27.4 | $34.0 | $27.7 |
| Net Pricing | $78.9 | $67.3 | $74.1 | $83.0 | $12.5 | -$24.2 | -$8.1 |

Total net pricing helped EPS by 91 cents. The Foodservice operation where egg costs have plummeted against $34 million in price hikes was 57 cents of the $0.91 and is almost the entire beat.

- FIFO accounting could now work against POST on gross margins as raw material costs decline in some areas and/or see the rate of increase decline further. Gross margin already saw pressure in 2Q23 despite heavy excess pricing being taken and 1Q23's margin was higher but not nearly as much as 3Q.

| | 3Q23 | 2Q23 | 1Q23 | 4Q22 | 3Q22 | 2Q22 | 1Q22 | 4Q21 | 3Q21 |
|---|---|---|---|---|---|---|---|---|---|
| Gross Margin | 27.0% | 25.5% | 26.5% | 24.9% | 23.9% | 26.8% | 25.1% | 24.5% | 29.5% |

Gross margin and inventory levels are difficult to assess for 3Q23 because POST has two months of acquired pet food sales in the period and added $205 million of inventory in the process. POST is claiming a 27.0% gross margin, up from 23.9% in 3Q22, due to its pricing gains. Pricing should help margin – we don't debate that. However, there is not enough information to remove the acquisition and look at the organic change. POST does provide a pro forma assessment of having owned the Pet Food brands since October 1, 2021. It shows that pro forma income drops from $175.9 million in 3Q22 to $116.6 million in 3Q23. Another explanation is that the pet foods business has a higher gross margin, but heavy SG&A costs explain a 310bp jump in gross margin. Also, $12.6 million was added back to adjusted earnings to remove gross margin pressure from stepped-up inventory values for the acquisition.

- POST had boosted earnings in the past by cutting advertising. It is now admitting that it needs to boost advertising and promotional spending to counter the impact of private label competitors hurting its volume. In total, volume was down $54 million in 3Q. The 10-Q only mentioned a $3.9 million increase in advertising and an unquantified bump in promotional spending for the Refrigerated Retail unit. On the earnings call, the company said TV commercials were coming back for cereal and the promotional spending is rising too. The $3.9 million was a 4.5-cent headwind, but it sounds like this should be expected to rise further. Higher promotional spending is netted against sales and would reduce the pricing impact. That should have negative implications for gross profit too.

- POST had been picking up some EPS in 1Q and 2Q with declining depreciation and amortization. In 3Q, we noticed that all segments that were not impacted by pet food were flat to slightly up in this area. Consumer Brands and Corporate were up y/y due to the Pet Foods deal. This source of EPS growth appears to have vanished.

# 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 2Q23 distributable earnings of 49 cents beat forecasts by 1 cent. Earnings continue to be hurt by STWD keeping liquidity high and waiting to boost investments. It still outearns its dividend and has enough liquidity plus repayments from loans coming in to support it. Book value is $21.60 using the fair value of its real estate properties so the stock is still trading at 4%-5% discount to that with a yield of 9.5%. Several levers remain to help grow earnings in our view:

- Non-accrual assets are costing STWD 20 cents per year as capital is tied up not earning interest. There are resolutions on-going, which will ultimately free up that capital for redeployment.

- The servicing segment is getting busier as a heavy period of refinancing has just begun in 2023. Liquidity issues and lack of bank lending are causing more loans to be restructured rather than simple refinancing. STWD gets paid in these situations and the more complex the solution the higher the payment. However, STWD gets paid at the end of the process. This is lumpy earnings but could soon start to exceed past levels:

| | 2Q23 | 1Q23 | 4Q22 | 3Q22 | 2Q22 | 1Q22 | 4Q21 |
|---|---|---|---|---|---|---|---|
| Invest/Spec Service | $0.07 | $0.04 | $0.10 | $0.10 | $0.11 | $0.09 | $0.15 |

- STWD has not talked about the impact of rising interest rates on income in recent quarters, but it was not until 3Q22 that 100% of its loans exceeded the interest rate floors STWD had in place. At that time SOFR was 3.0%, and is now 5.3%. Every 100bp is worth about 11 cents in earnings per year. Given STWD's normal operating model, we believe it has installed new floors on recent loans at much higher levels and may have increased floors on some existing loans to protect this higher income should rates decline.

- STWD is running at 2.4x leverage and hoarding liquidity waiting for signs of interest rates and credit spreads stabilizing. It also sees the servicing segment as a way to look closely at the underlying cash flow performance and value of properties having their capital restructured and a way to cherry-pick new deals to enter and has over $100 billion in deals with nearly $6 billion in active servicing now. Half a turn of leverage would add over $3 billion in assets, at a net 3%-5% would add about 28-45 cents per year to earnings.

- The rent on the apartments in Florida rose 7.5% to begin July. None of that hit in 2Q yet. The rents are tied to a backward look at inflation and wage growth in the area. There was a cap placed on some of the increase by HUD. The full amount will still be received, it will just be added to future rent hikes, so a second lag is being built in that will allow rent increases even if inflation becomes deflation. Plus, the rents cannot go down.

- STWD ramped up its CECL reserves using a tougher forecast and it added a $15 million specific reserve to a Phoenix property and another of $3.8 million for an infrastructure loan. The total charge for bad debt expense was $121.9 million which, lowers book value and GAAP earnings by 38 cents. For adjusted earnings – this 38 cents was added back.

    - Much of this reserve is against the STWD's US office exposure, which remains only 10% of the commercial lending portfolio.

    - STWD is reserved for a decay in those asset values > 42% by 2030.

    - CECL has also lowered book value by a total of 83 cents at this point, so the actual book could be $22.43 with the stock at a 9%-10% discount.

- On specific troubled loans that STWD has called out – three were upgraded in 2Q. There are potential new leases coming for some and recapitalization proposals in other cases. STWD is comfortable with being able to reach full recoveries on these properties. Its history of workouts, foreclosures, and repurposing has enabled STWD to avoid actual losses. The issue at the moment is these properties tie up equity without earning a cash return. STWD estimates this at 20 cents per year of lost adjusted earnings. 11 cents of this is from one property in New Jersey that is now cash flow positive and should be nearing a stage when this capital can produce earnings for STWD again.

- Multifamily loans are 20% of the portfolio. STWD again has loans out at 60%-65% of cost. Rents have already risen over the last three years to push up the cash flow on these properties from the 4s to over 6% cap rates. The occupancies remain high and higher interest rates restrict some new supply too. Higher interest rates can squeeze margins and interest coverage for the properties, but with demand strong and rents still rising, these have a different risk profile than office.

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

*We are raising our earnings quality rating of WBD to 4+ (Acceptable).*

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

## Summary

There is still too much going on at WBD with apples-to-oranges comparisons and reworking systems that this team inherited to be following it on more than a big-picture basis than quarterly EPS. We see the company exceeding its larger goals and doing it faster than anticipated. Plus, cash flow is improving – despite funding all the growth and restructuring initiatives. Guidance remains $11.0-$11.5 billion in EBITDA for 2023 – which would imply about 24%-34% growth y/y for the 2H. That looks doable:

- Cash flow is improving and should rise on auto-pilot. Free cash flow was $1.7 billion in 2Q23, it was $2.1 billion the prior four quarters combined. Cash restructuring charges were $1.4 billion the last five quarters and should not recur. Guidance is for $1.7 billion in 3Q23 and that quarter includes almost $900 million in interest payments on the bonds. **(See Below).**

- Cost cutting has accelerated and increased. Before the merger, the forecast was for $2 billion in cost savings and zero revenue synergies by 2024. Now the forecast is for $5 billion in cost savings by the end of 2024 with $2 billion already achieved by 2Q23. That has not annualized yet, but it it should rise going forward and give WBD returns that exceed initial forecasts. Cost savings is already noticeable when looking at y/y growth in EBITDA despite several headwinds:

| EBITDA | 4Q | 3Q | 2Q | 1Q |
|---|---|---|---|---|
| 2023 | | | $2,149 | $2,611 |
| 2022 | $2,603 | $2,424 | $1,766 | $2,381 |
| 2021 | $2,741 | $2,668 | | |

1Q21-2Q22 are pro forma.

- Advertising for the networks continues to decline since the summer of 2022 when WBD lowered guidance. Advertising is down $1.0-$1.1 billion annualized and WBD is forecasting more weakness for 3Q23 and 4Q23. Yet, at this point, the cost cutting is helping EBITDA grow despite this headwind. Even without the ad-market fully recovering, there are reasons to believe WBD can see advertising revenues increase. **(See Below)**

- Streaming has improved considerably since the merger was completed. The original thought was it would lose money in 2022 and 2023, and break-even in 2024. It actually turned profitable in early 2023 and has since raised prices during 2Q23 and expects to roll out internationally starting next year. This is another area where WBD can pick up advertising revenue too. That has not been the primary focus yet, but advertising is growing rapidly here.

| **Max EBITDA** | **4Q** | **3Q** | **2Q** | **1Q** |
|---|---|---|---|---|
| 2023 | | | -$3 | $50 |
| 2022 | -$217 | -$634 | -$558 | -$654 |
| 2021 | -$728 | -$309 | | |

| **Max Adv.** | **4Q** | **3Q** | **2Q** | **1Q** |
|---|---|---|---|---|
| 2023 | | | $121 | $103 |
| 2022 | $123 | $106 | $97 | $81 |
| 2021 | $70 | $54 | | |

- Debt is being retired. Debt is down to $44.7 billion and WBD tendered for another $2.7 billion after the quarter. The goal is to be below 4.0x EBITDA by year end and The low end of EBITDA guidance of $11.0-$11.5 billion would meet that goal. WBD is only trading for 7x EBITDA and EBITDA is growing. Every $2.4 billion of debt they retire – transfers $1 per share to the stock without enterprise value growing. Adding $1 billion in EBITDA at 7x, is almost $3 of new stock value.

We see this as WBD is missing $1 billion in advertising, will remove $5 billion in costs and its streaming service was as a huge money loser at the time of acquisition that is now a positive contributor. (Some of the streaming cuts are in the $5 billion.) There should be some solid growth in 2024 and 2025 in our view without advertising recovering.

## What to Watch

**The cash flow is improving and WBD is forecasting $1.7 billion in free cash flow for 3Q23 and we want to point out several items:**

| | 2Q23 | 1Q23 | 4Q22 | 3Q22 | 2Q22 | 1Q22 |
|---|---|---|---|---|---|---|
| Cash Ops | $2,014 | -$631 | $2,846 | $124 | $1,011 | $323 |
| Cap Ex | $292 | $299 | $364 | $316 | $222 | $85 |
| Free Cash | $1,722 | -$930 | $2,482 | -$192 | $789 | $238 |
| | | | | | | |
| Wrk Cap | -$2,734 | -$5,930 | -$2,450 | -$3,806 | -$3,594 | -$1,132 |
| Amtz content | $4,638 | $4,723 | $2,720 | $4,850 | $5,618 | $973 |

- In 1Q and 3Q, WBD's interest payments are due on its bonds of high $800-$900 million in cash outflow. That impact is very noticeable in cash from operations for 3Q22 and 1Q23. That's why we think it is noteworthy that WBD is forecasting $1.7 billion in free cash flow in 3Q23 despite having the interest payment.

- These cash flow numbers also reflect cash restructuring payments made. These were $1.4 billion from 2Q22 through 2Q23. The forecast is for a total of $1.5 billion and $200 million occurred in 2Q23. With those payments largely complete and unlikely to recur in a meaningful way, that alone should add to cash flow.

- Content spending is the largest part of working capital changes and is recurring cash outflow. The content spending gets capitalized and amortized over the time as it is shown to audiences. The table shows these items below the free cash flow line. After WBD was formed, management culled many projects and even some completed content. In the first few quarters, that led to script rewriting, and rebuilding a pipeline of new content ideas.

Thus, spending in this area was lower than normal, and the amortization of past content was producing the bulk of cash flow. 1Q23 saw a surge in new spending, which squeezed cash flow along with the bond payment. WBD expects there will be a narrower gap between content spending and amortization that should help cash flow too on a regular basis.

**Overcoming lower advertising – there are several routes:**

Advertising fell about $1 billion on an annualized basis soon after the merger was completed. Some of this is related to weakness in the advertising market overall being down about 11% since 3Q22. It remains weak – with WBD expecting it to be down y/y for 3Q and 4Q with some disruption due to regional sports networks winding down.

| Network Adv | 4Q | 3Q | 2Q | 1Q |
|---|---|---|---|---|
| 2023 | | | $2,448 | $2,237 |
| 2022 | $2,226 | $1,944 | $2,802 | $2,632 |
| 2021 | $2,683 | $2,268 | | |

- The figures for 3Q21-2Q22 represent pro forma figures for the combined operations.

- There are apples-to-oranges comps in some of this. The networks had the NCAA Final Four games in 2Q22 but not 2Q23. There were summer Olympics in 3Q21 but not 3Q22.

- WBD also rebuilt and reorganized its advertising sales team during 4Q22 and 3Q22. That was after and during times it pulled content off the networks too.

Forecasts from WBD for a year have reflected about $1 billion in lower-than-normal advertising rates from the pre-merger forecasts. Predicting when that recovers – has been a wildcard for forecasts that could improve results. Other things also point to higher advertising:

- The sales team has a larger pool of channels to sell at this point with the combination of Warner channels and Discovery channels and the content culling issues appear to be resolved at this point.

- There still are sports in play here with NBA and NHL where rates have improved.

- WBD has begun advertising with HBO and Max. It has added new tiers for pricing at Max that may cause more advertising to be sold. The company's view is it doesn't care if it collects $20/month from subscibers via purely content with no ads or $10/month in subscription revenue and $10/month in ad revenues. Advertising from the streaming service has been rising and likely represents an area for better improvement. On the 2Q call, even WBD noted that was not prioritized until very recently and was limited to a few shows. However, it sees great opportunity here. Looking at pro forma figures vs. recent results shows this source of advertising revenue is growing rapidly:

| Max Adv. | 4Q | 3Q | 2Q | 1Q |
|---|---|---|---|---|
| 2023 | | | $121 | $103 |
| 2022 | $123 | $106 | $97 | $81 |
| 2021 | $70 | $54 | | |

If WBD is light $1.0-$1.1 billion in traditional advertising and has some new sales teams in place to recover some of that – that would already be a positive. However, it may be able to replace more than half that lost revenue with advertising on Max within the next few quarters. We do not think the market is fully focused on that and continues to look at network TV advertising being down.

# 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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