BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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MDLZ 4Q19 Update
Maintain SELL

We are maintaining our SELL recommendation on MDLZ after the company's adjusted EPS came in at 61 cents beating forecasts by 1-cent, but we think that was aided by booking oversized price hikes from Latin America and then not accounting for the oversized FX loss in the $0.61. **Every point of price increase from Latin America is worth 0.4 cents in EPS for the quarter and they raised prices by 9.4% and lost 10.0% in FX. With that unit posting inflated sales and falling margins, we can easily see the results as a miss. Ignoring Europe's FX hit also helped lift organic growth and that was 1-cent for the quarter.** The company also beat revenue forecasts by $80 million with $70 million coming from the same price increase. Guidance at 3% organic growth for revenue looks weak coming off a 4.1% year and quarter too. Getting more product into club stores and discounters has helped drive volumes in 2019. We think that initial stocking will lap in 2020 and volume may return to the historically flat levels the company posts.

We need to update the Accounts Receivable figures for DSOs when we have the 10-K and can see the level of factoring MDLZ is using. The inventory figures looked good from the press release figures. **Accounts payable days were up 3 days y/y and now 12 days since 4Q16. That may not be able to produce as much cash flow in 2020.**

We have also talked about how the share repurchases are losing steam. **Guidance is to purchase $2 billion in stock this year from free cash flow of $3 billion. That will only produce about 2% EPS growth. MDLZ will also have a dividend in the $1.6-$1.7b range, so debt will increase again.**

- **Putting Latin America in the standard organic growth definition that excludes FX is skewing the results in our view. To deal with hyperinflation in Argentina, MDLZ is continuing to take huge price hikes which are being considered organic growth. The problem is the FX charge after organic growth continually exceeds the entire price hike.**

- **Even MDLZ is starting to admit that Argentina's outlying numbers are skewing the results. In the last three quarters, it has shown Latin America organic growth with and without Argentina on the slides in its presentation. In 4Q19, organic growth for Latin America was 7.6% but was only 1.7% without Argentina. 3Q19 was a reported 4.3% vs. a more realistic -1.5%.**

- **Latin America at 12% of sales is moving MDLZ's total growth rate. The unit is continually reporting growth at over 2x total MDLZ and had a 50-80bp impact on the total company's growth rate last year.**

- **Worse than that, while investors are cheering this source of sales growth – the unit itself is routinely posting declining volume, declining margins, and y/y operating income growth rates of -30%.**

- **While investors may cheer a growth rate that is still above 3.5% without Latin America – the rest of the world is not getting anything close to that level of price hikes. In fact, without adding back the FX hits for Europe and AMEA – MDLZ's growth is actually under 1%.** The stronger dollar acts as its own price increase to help local competitors against MDLZ. MDLZ has already said it has reversed the past margin gains it achieved by cutting marketing costs – in order to compete better overseas.

- **Keurig Dr. Pepper investment may have more risks than MDLZ investors realize – the company has a debt to equity ratio of 4.8x and is financing itself with commercial**

paper, a decent amount of short-maturity debt, and stretching payables by helping suppliers factor its obligations. Any issues with its debt rating may unwind some of that very quickly.

- **Keurig Dr. Pepper is also showing flat sales growth and may have already booked much of the synergies from the combing the businesses 18-months ago.** It is not boosting its dividend and produced 30-cents of MDLZ's $2.47 in EPS last year. Plus, only 17-cents arrived in cash.

- **Is MDLZ giving itself an easy hurdle with guidance of 3% organic growth or has initial stocking in new channels given a short-lived boost to volume?** The company has a long history of posting flat or negative volume growth. Suddenly it sees a jump in 2019 to 1.9% that built through the year. We know it was adding more distribution to discount stores and club stores. Given that pricing normally exceeds volume growth and the company's forecast is 3% vs. the 4% it just posted, we wonder if the volume results are sustainable.

Latin America's Sinking Ship Still Drives MDLZ Growth

Mondelez continues to tout its growth rate before FX. We have pointed out that hyperinflation in Argentina is driving pricing increases for MDLZ and other companies. In fact, it makes the Latin American region look like the strongest place on earth. We think this really causes investors to overstate growth when viewing the adjusted constant-currency results. In the last 8-quarters, Latin America has never had volume growth for MDLZ even against easy comps:

Latin America	4Q19	4Q18	3Q19	3Q18
Price chg.	9.4%	7.2%	8.9%	5.2%
Vol. chg.	-1.8%	-3.3%	-4.6%	-0.6%
Organic growth	**7.6%**	**3.9%**	**4.3%**	**4.6%**
FX Impact	-10.0%	-19.1%	-9.2%	-19.4%
Real growth	-2.4%	-15.2%	-4.9%	-14.8%
Total MDLZ growth	**4.1%**	**2.5%**	**4.2%**	**1.2%**

Latin America	2Q19	2Q18	1Q19	1Q18
Price chg.	11.5%	6.1%	9.9%	6.2%
Vol. chg.	-0.6%	-2.3%	-1.5%	-4.0%
Organic growth	**10.9%**	**3.8%**	**8.4%**	**2.2%**
FX Impact	-15.7%	-12.5%	-18.6%	-4.3%
Real growth	-4.8%	-8.7%	-10.2%	-2.1%
Total MDLZ growth	**4.6%**	**3.5%**	**3.7%**	**2.4%**

Notice that MDLZ has seen organic growth from Latin America accelerate in every quarter in 2019 except 3Q, when it was basically flat. However, the volume has been negative in every period and the real growth net of FX has been negative in every period. The reason, MDLZ is getting pricing is because the FX losses are so terrible. Yet, the higher pricing only offset the FX loss in 1Q18.

Also, notice that Latin American growth exceeds MDLZ's total organic growth in every quarter except 1Q18. Viewed in complete terms, Latin America is not a healthy market and is only 12% of the sales. However, it has a huge swing factor when comparing GAAP results vs. the constant currency figures MDLZ wants to tout:

GAAP Sales	2019	2018	Growth
Total Sales	$25,868	$25,938	-0.3%
Sales w/o L.A.	$22,850	$22,736	0.5%

Under GAAP, Latin America reduced the growth rate of MDLZ by 0.8%. It only posted 0.5% even adjusting for that.

Non GAAP Sales	2019	2018	Growth
Total Sales	$26,879	$25,812	4.1%
Sales w/o L.A.	$23,427	$22,610	3.6%

With the Non-GAAP results, Latin America inflated results by 0.5%. For people cheering the 3.6%, it is worth noting that FX being ignored for Europe added 2.0% to sales and in AMEA it added 0.7% in 2019. Thus, we're talking about a company doing 0.9% sales growth – of that, they have a 1.3% swing from Latin America depending on adjusting for the huge inflation in price with or without the even larger FX loss.

The company has started to call out Argentina's impact on organic growth in the last three quarters and it really highlights this problem with the reported growth figures. Here is what Latin American growth looks like as it drives MDLZ core growth and what it looks like without Argentina in the mix:

	4Q19	3Q19	2Q19
Org LA growth	7.6%	4.3%	10.9%
Org LA without Arg.	1.9%	-1.5%	4.2%

More importantly, Latin America's profits and margins are also declining – so how much is this FX driven growth really worth?

LA Op Income	4Q19	3Q19	2Q19	1Q19	2019
2019 LA Adj Op Inc.	$136	$122	$104	$133	$495
2019 LA Adj Op Inc. w/ FX	$111	$99	$87	$115	$412
2018 LA Adj Op Inc.	$101	$140	$119	$165	$525
Reported Op Inc Growth	34.7%	-12.9%	-12.6%	-19.4%	-5.7%
Op Inc. Growth w/ FX	9.9%	-29.3%	-26.9%	-30.3%	-21.5%

Latin America has a lower profit margin than the rest of MDLZ and in 2017 the division had $553 million in adjusted operating profit, in 2019 it was $412 million – down 25% on explosive sales growth.

While We are Looking at FX – Is Europe or AMEA Really Growing? And How About Those Forecasts?

We mentioned above that pulling Latin America out of the mix – cuts MDLZ's organic growth rate from 4.1% to 3.6%. That still gives them credit for adding back FX and Europe's reported growth is heavily tied to that adjustment. Adjusting for FX for Europe would cut the 3.6% growth to 1.6% and adjusting for AMEA after that cuts the 1.6% to 0.9%.

The first thing we would say is that these markets are acting more like what a strong dollar normally does. A strong dollar tends to make US exports less competitive on price and in order to grow volumes – pricing tends to be much weaker. In periods when the foreign currency rallies, pricing gets stronger and/or volume growth tends to be higher. MDLZ is getting little pricing of late and what they do get is more than offset by FX losses:

Europe	4Q19	3Q19	2Q19	1Q19	2019
Pricing	-0.5%	0.3%	0.3%	0.0%	0.0%
Volume	3.8%	4.7%	3.6%	2.7%	3.7%
Organic Growth	3.3%	5.0%	3.9%	2.7%	3.7%
FX	-1.7%	-4.3%	-6.3%	-8.4%	-5.2%
Real Growth	1.6%	0.7%	-2.4%	-5.7%	-1.5%

AMEA	4Q19	3Q19	2Q19	1Q19	2019
Pricing	2.6%	1.7%	1.9%	1.1%	1.7%
Volume	2.3%	3.6%	2.8%	5.0%	3.6%
Organic Growth	4.9%	5.3%	4.7%	6.1%	5.3%
FX	-2.9%	-3.8%	-5.3%	-6.0%	-4.6%
Real Growth	2.0%	1.5%	-0.6%	-0.1%	0.7%

In both cases, these situations are improving as the FX losses are decreasing and helping actual growth turn positive. It is interesting to us that MDLZ continues to post weak guidance on revenues:

- 4Q18 – 2019 guidance was 2-3% organic growth
- 1Q19 – MDLZ had 3.7% growth – guidance was 2-3% organic growth
- 2Q19 – MDLZ had 4.6% growth – guidance was raised to 3% organic growth
- 3Q19 – MDLZ had 4.2% growth – guidance was raised to 3.5% organic growth
- 4Q19 – MDLZ hits 4.1% growth – 2020 guidance at 3%+ organic growth

That was the first question out of the gate on the call and management noted that some categories were running about 2.8% growth rather than 4.0% earlier in 2019, it is watching China, and has more work to do in Brazil.

Coffee JVs May See Slowing Growth and Balance Sheet Issues

We noted after 3Q results that merging the various coffee JVs into Keurig Dr. Pepper resulted in a $778 million gain for MDLZ in 2018. The company's cash flow rose as the new venture started paying a $0.15 quarterly dividend. That dividend has not grown and MDLZ benefited on cash flow from having received four quarters of dividend in 2019. The equity income on MDLZ declined in 2019:

Equity Income	2019	2018
Equity Gains	-$2	$778
Equity Income	$442	$548
Cash Received	$250	$180
Adj. EPS	$2.47	$2.42
EPS from JV	$0.30	$0.37
Cash EPS	$0.17	$0.12

The dividend isn't growing at this point. There was even a tax-sharing agreement between the two companies that ended in September 2019 and had Keurig paying $16 million to MDLZ. We believe the cash EPS from this deal will at best be flat going forward.

On top of that, this was a merger involving several companies in 2018. There was some sizeable integration and cost-cutting that happened quickly. That gave Keurig some operating income growth through September 2019. On a proforma basis – the growth was 9.4% on operating income. The company adjusted for integration costs to reach that figure.

It is not clear if the inventory step-up in 2018 was backed out. That is only mentioned in talking about 3Q results not 9-month figures, but it was a $131 million headwind for 3Q18 vs. 3Q19. It helped gross margin in 3Q19 by 480bp. If it was not part of the 9-month adjusted results – then the proforma growth may only be 2.4%. The discussion indicates Keurig benefited from synergies but faced headwinds on higher input costs. There also is no real revenue growth:

Keurig DrP	9 mths 19	9 mths 18	3Q19	3Q18
Pro forma Rev.	$8,186	$8,211	$2,870	$2,856
Pro forma Op. Inc.	$2,077	$1,898	$754	$698

The pro forma operating income gain slowed to 8.0% from 9.4% for the full nine months.

Also, investors should focus on where Keurig's cash flow is coming from – accounts payable. The company sets up deals with suppliers to factor its payables. They had $1.9 billion of payables factored on 9/30/19 up from $1.4 billion on 12/31/18. Total payables rose to $3.0 billion from $2.3 billion. Sales are flat!!

For the nine months ended 9/30/19 – cash flow stats are helped significantly from boosting payables to 218 days.

Keurig DrP	9 mths 19
Cash Ops	$1,803
Cash from A/P	$561
CapX	$208
FCF Adj	$1,034
Dividend	$633

Also keep in mind that Keurig Dr. Pepper has $74 million in cash and owes $15.0 billion, which doesn't include the $1.9 billion in payables being factored. The 15.0 billion in debt against an adjusted EBITDA of $3.1 billion is a Debt/EBITDA ratio of 4.8x. Of that $15.0 billion, $1.4 billion is commercial paper and along with the $1.9 billion in payables – likely hinge on the company's credit rating to roll it over. They also have $2.25 billion in debt maturities in 2021.

The Increase in Volume May Be Due to Initial Stocking

One of the other reasons we question the growth and restructuring success at MDLZ is it never seems to produce much in the way of results. For example, in 2014 – it announced another restructuring program for $3.5 billion to grow the business and boost adjusted operating margins to 17%-18% by 2018.

The result was MDLZ hit 16.7% in 2018 and announced a continuation of the restructuring through 2022. In 2019, the adjusted margin was 16.5%. We were pointing out during those years, MDLZ cut $223 million out of the advertising budget, which added 86bp to margin and it held R&D basically flat. We will need to see the 10-K, but MDLZ noted that it boosted marketing by about $150 million in 2019 and expects to boost it another $150 million in 2020. Given guidance of 3% organic revenue growth and high single-digit EPS growth that will include about 2% growth from share repurchases, it does not sound like they are counting on much operating margin growth in 2020.

Plus, the company is finally seeing some volume growth:

	2019	2018	2017	2016	2015
Volume Growth	1.9%	1.0%	-0.6%	-0.3%	-3.1%

	4Q19	3Q19	2Q19	1Q19
Volume Growth	2.2%	2.1%	1.6%	1.7%

Looking at 2018, that is likely bouncing off three negative years. In 2019, the company talked glowingly about entering many more stores in particular club stores and discount retailers. We think that helped stock more inventory and boost sales. The focus is to repeat that in 2020. So again, why cut the forecast? Normally, more of the organic growth comes from pricing and the company is running over 2% in volume at the end of 2019 – how can the forecast be for 3%?

If that recent volume growth came from initial stocking, that level of growth may not repeat, and guidance makes more sense.

AT&T (T) 4Q Update
Maintain BUY

We are maintaining a BUY recommendation on AT&T after it beat EPS estimates by 1-cent. The market continues to hate the results for TV and the transition to HBO Max streaming. AT&T also laid out guidance for a backloaded 2020 based on heavy investment for HBO Max in the 1Q and 2Q before launch in May. We understand those concerns are out there (and have been for years) and continue to believe that investors are ignoring that the core communications business is growing with higher free cash flow and the balance sheet has improved considerably. The stock is still only 10x forward EPS, 7x EBITDA with a 5.5% yield. We think the low valuation gives plenty of cushion to live with the lumpiness of early 2020.

We have talked about many aspects of the entertainment business in the past and the transitions – but we think if investors focus on some key points for the communications business the value becomes apparent. We are going to keep this update short as we have covered some of these topics in-depth recently. One area we are going to add more discussion to is copper-wire retirement which can further reduce costs at AT&T.

- **Wireless is $30 billion of the company's $60 million of EBITDA. It has 166 million subscribers and connected devices. The connection rate is growing over 3 million per quarter.** Capital spending has been higher there with the FirstNet and 5G build-outs and that should decline going forward boosting free cash flow. Gross capital spending is expected to be about $20 billion in 2020. There should also be $1 billion in government reimbursements on FirstNet. That should be over $2 billion lower than 2019's figures of $23 billion with $1 billion of FirstNet reimbursement.

- **FirstNet build-out is now 75% complete. That results in new customers connecting in an area where AT&T previously had very little exposure.** Direct people such as police, firefighters, FBI gives a pool of 3 million people that can connect and many will connect with multiple devices. Also, another 8 million people at hospitals, utilities, disaster relief, etc. also have the potential to join FirstNet. Then AT&T can offer those people family plans too.

- **5G will be nationwide this summer. That should spur more demand for AT&T wireless and they will also be offering people HBO Max at the same time as well as**

new smartphone upgrades. That should also help push more people toward more premium unlimited plans – where penetration is only 50%.

- **Considering a higher number of people on AT&T's network and many more likely to be postpaid accounts and others tied to work and/or bundles – the churn rate should decline at the same time the customer numbers are rising. On the 4Q19 call, the company noted that a reduction of 1bp of churn is worth $100 million annually.** Churn is running just over 100-130bp now. It is worth noting that postpaid accounts pay about 10% higher revenues and typically have a 20-25bp lower churn rate.

- **To us, the discussion of AT&T should start with the fact that the largest unit is growing. It has multiple near-term catalysts to continue growing.** It has catalysts to upsell people to higher revenues and has catalysts to reduce costs already at work – the EBITDA margins are rising y/y now.

- **Retiring copper lines is happening – AT&T wrote off $1.3 billion of copper facilities in 4Q.** This has implications for pulling costs out of the Business Wireline division which does about $10 billion in EBITDA and the legacy voice business located in the Entertainment unit. This is a hidden way for AT&T to boost margins over time we spoke of when we first wrote the company in the summer of 2018.

- **AT&T is operating two phone systems – legacy copper and new fiber.** The number of users on copper is declining, but the maintenance costs often require the same investment to serve 10,000 people or 1,000. Copper uses higher cost labor, uses electricity, and is often above ground and suffers storm damage. Fiber is the reverse of that and has a higher capacity as well.

- **The FCC wants to accelerate broadband rollout and availability and in 2017 passed rules to streamline the process to make it easier for telecom companies to retire rather than maintain and repair copper and allow that money to be invested in higher ROI areas** like fiber. The FCC goal is to get more people covered by high-speed broadband and fiber. Since 2017, it has worked to reduce regulations even more that kept copper lines going. New rules allow for greater freedom to abandon copper and replace it with fiber in last-mile loops and rural areas too. It is highlighting again that the old rules locked companies and customers into supporting old technology rather than embrace new technology.

- **The FCC highlighted that phone companies could save $40-$50 per home per year in maintenance costs if they were allowed to fully transition away from copper when these changes to old regulations were debated.** This is not going to be a snap of the fingers and copper is turned off – but we see that as a long term source of cost savings as copper retirement continues. **On the 4Q19 call, AT&T highlighted it expects to save $1.5 billion in costs in 2020 largely with a 4% reduction in labor costs.** It highlighted another $2 billion in cost reductions by 2022 from areas that included "modernizing our information technology" and "thinning the product portfolio." To us, it should like some of the copper retirements is appearing in these areas.

- **Interest expense will be down in 2020. The company paid down $20 billion in debt during 2019. That alone will boost free cash flow by at least $600 million.** Debt payments will likely in the $6-$7 billion range this year – so that frees up $14 billion in free cash flow too for 2020, plus the company is starting with $7 billion more in cash.

- **Mexico became EBITDA positive in 4Q19 too** – as the heavy capital spending was completed and added more subscribers. That unit had a -$547 million in EBITDA in 2018 and -$216 million in 2019. It looks set to be a positive figure for 2020. There is a nice swing to take note of too.

Our Conclusion:

We think there is significant cushion built-in to AT&T to deal with all the commitments and a lumpy 1H that includes the roll-out of HBO Max startup costs and the transition of more current TV customers to HBO Max. On top of that, the Entertainment unit that receives all the negative attention – posted flat EBITDA last year of $10 billion. ARPU for TV is up 8% and broadband up 3%. That is hardly the collapse the media has forecast 2+ years.

Here are the negatives for 2020 based on our estimates:

- $800 million EBITDA hit for making WarnerMedia shows exclusive to HBO Max before the rollout
- $200 million EBITDA hit in 1Q as that is the last period of roll-off from discounted TV plans
- $2.0 billion in costs for HBO Max

That's $3.0 billion in negatives for cash flow – call us optimistic and say it's $3.5 billion.

Here are the positives for cash flow for 2020 from 2019:

- $600 million lower interest expense
- $300 million improvement in Mexico EBITDA
- $1.5 billion of cost savings already identified and half already implemented
- $2.0 billion in lower capital spending
- $4.0 billion in lower debt payments – reduced asset sales (Debt payments of $20b in 2019 become $6b so +$14b) and (asset sales of $18b in 2019 become $8b or -$10b)

That's $8.4 billion in positive swings for cash flow in 2020. The positive cash flow swings do not assume: growth in the wireless unit from FirstNet or 5G or reductions in churn or upgrading more people to unlimited and postpaid plans. They also assume no revenue from HBO Max.

Obviously, there is a transition going on here. The stock price continues to reflect that with a low valuation and above-average yield. The area of concern is TV which is about 7% of EBITDA and transitioning to streaming. **This stock continues to be taken to the woodshed over deals from years ago. We understand that and we were not the biggest fans of the acquisitions either. But the question to us remains, what else is here?**

Against the TV negatives, the groundwork has been laid for the largest unit at 50% of EBITDA to realize some solid gains this year from multiple avenues. We think that is being ignored. We also think investors are glossing over that the balance sheet and liquidity have been improved significantly and the amount of cash being returned to shareholders is rising rapidly. **Even if Warner and TV were split off and took $70 million of the remaining debt – the rest of AT&T would have a growing EBITDA of $40-$45b that would probably trade at a higher multiple.** At 8-9x EBITDA and only $80 million in debt– the communications and broadband assets are likely worth more what the whole company is trading for now. Plus, throw DirecTV away, we know Warner has good assets and was trading at a higher multiple before all this. There's probably still a $7/share value right there.

D.R. Horton (DHI) EQ Update
12/19 Quarter

Current EQ Rating*	Previous EQ Rating
4+	4+

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

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

The cyclical nature of the company and industry makes continual improvement in results difficult. We feared last year that DHI could have some negative news on pricing trends, volume trends, and that impairments could not remain at extremely low levels. All of those trends modestly retreated in fiscal 2019. In terms of earnings quality and low risk of write-down, we consider DRI among the top in the group. The ultimate risk remains a write-down in inventories – but there are not many signs of that at this time.

The basics of the inventory write-down stem from homebuilders have a large inventory balance with much of it still under construction. Where big problems arise is not from forfeiting deposits on future lots, but the company has to estimate the cost to complete current projects, estimate the future sales prices, and estimate the time until the sale and discount that back to NPV. Thus, the size of the write-down can become larger than the current inventory figure.

For that risk to be a realistic near-term problem we think there need to be signs that the cancelation rate is rising – but it is actually ticking down at DHI. There would need to be signs that unit volumes are falling – but they are not, DHI just raised guidance for units. Widespread signs that prices for houses are falling are not happening other than in the West where DHI has fairly low exposure. Also, minor impairments on spec homes and other needed modifications should be rising noticeably – but remain near record lows at DHI.

We want to highlight that DHI posted higher EPS in fiscal 2019 and raised guidance after 1Q20.

	f2019	f2018	f2017
EPS	$4.29	$3.81	$2.74
Dividend	$0.60	$0.50	$0.40
Shares O/S	377.4	383.4	378.9
Sales $ in bills	$17.6	$16.1	$14.1
Homebuild GM	20.2%	21.3%	20.0%

- **Impairments rose off very low levels and became a 6-cent headwind in 2019 vs. 2018. If it rises to $100 million in 2020, it would be a 10-cent headwind.**

- **Purchase accounting adjustments on inventory was a 4-cent EPS headwind in 2019.** Marking up values of inventory is actually a positive sign that impairments are unlikely to rise much in the near term.

- **The acquisitions have helped DHI add land at lower prices. The company's cost structure should also be helped that lots under option have remained flat for years** as costs of building homes has increased lately. Flat lot prices should mitigate margin pressure.

- **Gross margin came under pressure from building costs rising faster than selling prices. Even with lower margins in 2019, the rising unit volume more than offset that pressure.** Current guidance on units would need to see another 100bp of gross margin pressure by our estimates to make EPS growth 0-18 cents. Our concern last year was that gross margin was unsustainable, but it has returned to levels posted in 2016 and 2017.

- **Given less exposure to California and thus less exposure to negative home pricing, we see little risk of near-term sizeable inventory impairments at DHI.** Recently boosted unit sales guidance also gives more cushion against inventory impairments as that volume can offset the margin pressure.

Impairments Were up in 2019 as We Thought Might Be the Case – EPS Hurt by 6-Cents in 2019

Impairments	f2019	f2018	f2017
Land	$28.3	$13.4	$17.0
Home Inv.	$24.9	$10.9	$23.2

In 2019, impairments cost the company 11-cents in EPS vs 5-cents in 2018. Compared to periods such as 2007 and 2008 when impairments were $1.2 billion and $2.4 billion – these figures remain very modest and rising from 15bp of margin to 30bp in 2019 and are simply a cost of doing business. There is $5.9 billion in land and lot inventories and $5.2 billion in home inventories. **We do not see enough evidence to call this out as a problem. To us, it was simply a situation of it being very tough to maintain very low 2018 levels.**

In our view, the recent increases in home and land prices limited write-downs. In 2018 and 2019, the price increases stalled:

Pricing y/y	f2019	f2018	f2017	f2016
Full DHI	0%	0%	2%	2%
Southeast	1%	1%	1%	1%
South Central	0%	0%	4%	4%
West	-3%	-2%	5%	6%

Now when a house is taken back via cancellation or a modification has to be made, the company is not experiencing price appreciation at past levels. A part of the impairment calculation includes forecasting what additional costs still must occur before the property is sold, and higher prices may not be helping to offset the higher costs. Also, it is discounting its inventory's cash flows to compute impairments at 16%-18%. Thus, delays in getting to a sale can also push down the carrying value of the inventory.

This has also seen some of the gross margin coming off the highs of 2018. Of the five regional markets served DHI – the East (13% of sales) noted that gross margin fell 130bp due to the average cost of homes rising faster than the average selling price. The South Central (25%) of sales reported a 50bp drop in gross margin due to home costs rising faster than home prices. The West (21% of sales) saw a 270bp decline in gross margin as selling prices declined against a small increase in home costs. Only the Southwest (5% of sales) reported at 130bp increase as home prices growth exceeded increases in costs.

In the near term, sales remain brisk and the company boosted sales guidance. As we'll discuss later, they also still own their land fairly inexpensively. DHI also focuses on lower-priced and entry-level homes too. That also limits impairments. **Even if impairments rise to $100 million – it becomes a 10-cent headwind on EPS.**

Purchase Accounting for Acquisitions Hurt Gross Margin and EPS by 4-cents in 2019

Another reason sizeable inventory impairments seem unlikely in the near future is after making some modest acquisitions – the accounting after the close boosted the value of the acquired inventory. In 2019, there were three small deals, the inventory purchase adjustment boosted Cost of Goods by $18.5 million. That was a 4-cent issue for EPS.

The company noted that this was 10bp of total gross margin decline for the year. We didn't mention the Midwest unit above on gross margin because it bore the brunt this inventory write-up. The Midwest is only 7% of total sales but saw a 360bp gross margin decline last year largely due to the purchase accounting.

In 2018, there was a similar deal with the Forestar acquisition that boosted Cost of Goods by $17 million and cost the company about 4-cents in EPS in 2018 also.

The purpose of acquisitions was to acquire more control over land for future homes. So, it is definitely in the DHI wheel-house. Also, the acquisition costs were fairly modest and the company can easily afford it. There is $1.6 billion in cash after making acquisitions of $316 million and $159 million. Debt to equity is only 0.36x. Net of the cash, that ratio is only 0.21x. From a cash flow standpoint, working capital consumes cash when the company is growing in the form of mortgages and inventory of lots and houses under construction. Free cash flow before working capital growth was $1.66 billion in 2019.

We also believe the acquisitions have given the company the ability to acquire lots for a low price. The total purchase price in 2019 was $326 million and came with 700 homes in inventory, 4,500 lots, and another 4,300 lots with purchase contracts. The average home DHI sells in the Midwest is about $340,000-$350,000. Let's say the acquired homes are worth $300,000 * 700 units or $210 million. **Allocating the remaining 4,500 lots over $116 million is under $26,000 per unit and giving zero value to the purchase options on 4,300 other lots.**

In 2018, before the acquisitions, DHI had $208 million invested in 3,800 Midwest lots or an average unit price of $54,740. That's overstating the figure as there were 9,300 lots under contract that had some impact on the total $208 million figure. But, we think DHI was able to buy assets lower than what it had been paying and get a large amount of land in three transactions.

Total Gross Margin Came Under Pressure in 2019 – Higher Volume Offset It – It May Continue

Homebuilding margins were down 110bp last year. The company was hurt by the purchase adjustments noted above for 10bp and helped by 10bp due to lower capitalized interest amortization and 20bp from lower warranty/defect costs. The other 90bp of net lower margin came from average building costs rising faster than average home prices.

Given recent pricing trends, we do not see relief coming for margins. At the same time, we have always liked DHI for a small exposure to California. The West region is only 21% of sales and includes Washington, Oregon, Nevada, Utah, and Hawaii also. That is the one area that is seeing falling prices and would negatively impact gross margin.

Also, looking at the lots under option with the deposits and remaining purchase options, we think DHI has done a good job holding its future land costs fairly flat:

Lot Options	f2019	f2018	f2017	f2016
Units	185,900	164,200	124,000	91,600
Deposits	$515.4	$401.8	$227.6	$167.0
Remaining Payments	$7,200.0	$6,500.0	$4,600.0	$3,600.0
Price/Lot	$41.5	$42.0	$38.9	$41.1

The lot options have been fairly steady at about $41,000 per unit. Also, the average selling price of a house at DHI is $298,000, which makes the lot cost under 14% of the total price. We think that gives DHI some cost relief.

The bigger picture is volume is still growing rapidly:

	f2019	f2018	f2017
Units Closed	56,975	51,857	45,751
Unit Growth	9.9%	13.3%	13.5%

January forecasts are for f2020 to come in at 60,000-61,500 units, which is 5.3%-7.9% growth.

The gross margin decay in 2019 was more than offset by the higher volume:

	f2019	f2018	f2017
Home build Rev	$16,925	$15,502	$13,653
Home build GM	20.2%	21.3%	20.0%
Gross Profit	$3,419	$3,302	$2,731
Change from Vol.	$304	$369	
Change from GM	-$187	$202	

In 2019, the margin decay in homebuilding cost 39-cents in EPS, but volume added 64-cents. When we apply the unit guidance for 2020 – on flat gross margins – EPS would grow 38-57 cents. A 50bp decline of gross margin on unit guidance would still lead to 19-37 cents of EPS growth. A 100bp decline would still have EPS growth between 0-18 cents.

Stryker (SYK) EQ Review
Initial Look at 12/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

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

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

SYK reported adjusted EPS of $2.49 in the fourth quarter, 3 cps ahead of consensus estimates.

- We note that the company's accounts receivable days of sales jumped by almost 8 days over the year-ago quarter following an almost 4-day jump in the previous quarter. We are skeptical that acquisitions accounted for all of the increase. Organic sales growth has been strong, but the growth has been spread fairly evenly between US and international sales which seems to rule out a disproportionate growth in slower-paying international receivables. The fourth quarter DSO is also 7-8 days higher than the last three fiscal fourth quarters making it look very elevated historically. We find the increase to be concerning and worthy of attention, but given the strong organic growth and the earnings and sales beats posted in the quarter, we are inclined to keep our rating at 3- (Minor Concern) rather than reducing it to Weak at this point. (Click on the full report for a more detailed discussion,)

Accounts Receivables DSOs Jumped by More than Nine Days

The following table shows accounts receivable days of sales (DSOs) rose by almost 89 days over the year-ago quarter

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Sales	$4,131	$3,587	$3,650	$3,516
Trade Receivables	$2,893	$2,438	$2,408	$2,284
DSOs	64.4	62.5	60.0	58.5

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Sales	$3,796	$3,242	$3,322	$3,241
Accounts Receivable, Trade	$2,332	$2,076	$2,089	$2,108
DSOs	56.5	58.9	57.2	58.5

Note that the DSO of more than 64 compares to DSOs of 56.5, 58.3 and 57.3 for the 2018, 2017, and 2016 fourth quarters, respectively, making the current reading look very much out of place historically. Also, an examination of the year-over-year growth trends in receivables and sales provides more insight into the noticeable ramp up in receivables starting in the 6/19 quarter and accelerating thereafter:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019	12/31/2018	9/30/2018
YOY Receivables Growth	24.1%	17.4%	15.3%	8.3%	6.1%	5.6%
YOY Sales Growth	8.8%	10.6%	9.9%	8.5%	9.4%	7.9%

The company acquired K2M Group Holdings in November of 2018 for roughly $1.4 billion. This likely would have inflated DSO in the 12/18 quarter as K2M receivables hit the balance sheet in full but the quarter had fewer than two months of K2M revenues in the ratio. It is also telling that DSO remained flat in the 3/19 quarter, the first full quarter after the deal.

SYK acquired OrthoSpace in March of 2019 for $110 million and made other minor throughout the rest of 2019. However, this acquisition was not material enough for the company to disclose an itemized purchase price breakdown showing how much was booked as receivables making it unlikely the deal had a very material impact on DSO trends.

On October 21st of 2019, SYK acquired Mobius Imaging and Cardan Robotics for $370 million. The size of the acquisition and the quarter containing over two months of Mobius sales to match against the acquired receivables balance makes us skeptical that this could have had a huge impact on DSOs. The preliminary purchase price allocation was not performed until the fourth quarter so we will not see how much was allocated to receivables until the 10-K is released.

It is worth noting that SYK has been posting strong revenue growth, with constant currency revenue growth of 9.4% and acquisition-adjusted growth of 8.0% in the fourth quarter. Sales growth has been evenly split between US and overseas, so a shift to international sales with longer collection times does not seem to be a significant contributor to the DSO jump. Strong revenue growth can cause a modest rise in DSOs, and it conceivable that an acquisition could have added another day or two. However, an 8-day jump is concerning and could be an indication that sales were pulled into the fourth quarter at the expense of the upcoming first quarter. To put this in perspective, one day of sales is approximately $45 million and the company posted a $335 million YOY increase in revenue in the fourth quarter.

We have seen no discussion of the receivables increase in the last two 10-Qs or conference calls. However, given the company's strong revenue growth and the fact that it beat both EPS and sales targets in the quarter, we choose to leave our rating at 3- (Minor Concern) rather than reducing it to Weak. We will update if warranted after the 10-K is released.

McCormick (MKC) EQ Review- 11/19 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3+

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

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

MKC reported in-line earnings for the fourth fiscal quarter ended 11/29. However, revenues came up short of the consensus target and guidance for fiscal 2020 was well below the market's expectations. We are lowering our earnings quality rating largely due to the upcoming expiration of an earnings tailwind from lower pension costs.

- Lower pension costs have been adding about 3 cps to EPS growth for the last several quarters. This has been driven by declines in service cost from a series of pension freezes, a related decline in amortization of actuarial losses, as well as an increase to amortization of service credits related to changes in postretirement benefit plans. The decline in service cost will moderate in 2020 and the benefit from lower amortization of actuarial losses should decline or possibly reverse with lower a lower discount rate. Non-GAAP pretax income rose by 4% in the 11/19 quarter but that would have fallen to 2.2% without the lower pension expense.

- Accounts payable continued to skyrocket with days payable jumping to 90 days from 75 in the year-ago fourth quarter. We estimate this accounted for over half the reported increase in operating cash flow.

- The liability for estimated allowances for rebates, discounts, and returns at the end of the year fell on a slight increase in sales. We estimate that the decline relative to sales could have added about 3 cps to earnings during the year. Since the company only discloses the account on an annual basis it is impossible to tell when the impact fell. If the benefit came at the end of the year, it could have been a material boost to fourth-quarter results.

Pension Expense Decline Should Moderate Going Forward

MKC has made several changes to its pension and postretirement benefit structure over the last few years. On November 30, 2018, the company stopped accruing pension benefits for US employees as it had already done with its UK plan on December 31, 2016. The US Plan freeze can be seen in the decline in service cost starting in the 2/19 quarter in table 1 below:

Table 1

	11/30/2019	8/31/2019	5/31/2019	2/28/2019
Service Cost	$1.8	$1.9	$1.9	$1.9
Interest Cost	$11.7	$11.6	$11.6	$11.7
Expected Return on Plan Assets	-$14.8	-$14.6	-$14.8	-$14.7
Amortization of Prior Service Costs/(Credits)	-$1.9	-$2.1	-$2.0	-$2.0
Amortization of Net Losses/(Gains)	$0.4	$0.8	$0.7	$0.7
Settlement Losses	$0.0	$0.0	$0.0	$0.0
Total Pension/Postemployment Benefit Expense	-$2.8	-$2.4	-$2.6	-$2.4

	11/30/2018	8/31/2018	5/31/2018	2/28/2018
Service Cost	$5.2	$6.0	$6.0	$6.1
Interest Cost	$10.7	$10.8	$10.8	$10.9
Expected Return on Plan Assets	-$15.2	-$14.8	-$15.0	-$15.0
Amortization of Prior Service Costs/(Credits)	-$2.5	-$2.2	-$2.1	-$1.7
Amortization of Net Losses/(Gains)	$3.1	$3.1	$3.2	$3.2
Settlement Losses	$0.5	$0.0	$0.0	$0.0
Total Pension/Postemployment Benefit Expense	$1.8	$2.9	$2.9	$3.5

The US and UK plan freezes resulted in a reduction in the plan obligation of $77.7 million which produced an actuarial gain booked in other comprehensive income recognized in fiscal 2017. Effective November 30, 2019, the company will stop accruing benefits for participants in its Canadian pension plan. Since the freeze was approved in 2018, the company reduced its pension obligation by $17.5 million in that year as well as recognizing an actuarial gain in other comprehensive income.

Finally, the company made changes to its postretirement benefits plan to consolidate benefit providers, simplified/reduced its subsidy for postretirement benefits, as well as eliminated the life insurance benefits election for employees who were planning to retire prior to December 31, 2018. As a result of these changes, the company recorded a $27.1 million reduction in postretirement benefit obligation and a gain in comprehensive income which is being amortized into pension expense/income. Referring to Table 1, almost all the approximate $2 million quarterly income on the "Amortization of Prior Service Costs (Credits)" line is being generated by the amortization of the postretirement income credit. Roughly $20 million of the $27.1 million credit has been recognized as income. At a $2 million quarterly run rate, this should last through fiscal 2020 but will run out shortly after that.

In addition to the US plan freezes/changes, the pension obligation was likewise reduced during fiscal 2018 by an increase in the assumed discount rate used to determine the PBO seen below in Table 2.

Table 2

Benefit Obligations Assumptions

	11/30/2019	11/30/2018	11/30/2017
United States Plan			
Discount Rate- Funded Plan	3.4%	4.7%	4.0%
Discount Rate- Unfunded Plan	3.3%	4.6%	4.6%
International Plans			
Discount Rate- Funded Plan	2.2%	3.3%	3.0%
Rate of Compensation Increase	2.9%	3.0-3.5%	3.0-3.5%

The actuarial gain from the plan freeze and the increase in discount rate in fiscal 2018 drove the decline in the amortization of actuarial loss seen in Table 1 which has been another key source of the decline in pension expense.

However, this situation has now reversed as higher rates have led to an increase in the pension obligation shown in Table 3 below:

Table 3

Funded Status	11/30/2019	11/30/2018	11/30/2017
United States Plan			
Benefit Obligation	$885	$753	$814
Fair Value of Plan Assets	$672	$640	$654
United States Plan Funded/(Unfunded) Status	-$213	-$112	-$160
International Plans			
Benefit Obligation	$346	$293	$342
Fair Value of Plan Assets	$341	$307	$331
International Plans Funded/(Unfunded) Status	-$5	$14	-$10
Total			
Total Benefit Obligation	$1,230	$1,046	$1,155
Total Fair Value of Plan Assets	$1,013	$947	$986
Funded Status	-$218	-$99	-$170

The Canadian freeze effective November 2019 should drive pension service cost to essentially zero in fiscal 2020 which could produce an approximate $1.5 million quarterly earnings headwind. However, the benefit from lower amortization of actuarial loss will wane and likely reverse as the benefit from a higher assumed discount rate and absence of gains from plan freezes will have passed. As noted earlier, the $2 million amortized gain from service credits to the postretirement benefit changes should continue to benefit earnings this year but will expire soon thereafter.

Lower pension expense has been adding about 3 cps to earnings growth each quarter in fiscal 2019. MKC's adjusted tax rate has been very volatile given the impact of stock option exercises, so we will use non-GAAP pretax income adjusted for special charges and transaction costs as a proxy for core growth. Table 4 below shows growth in non-GAAP pretax income before and after the decline in pension expense:

Table 4

	11/30/2019	8/31/2019	5/31/2019	2/28/2019
Non-GAAP Pretax Income	$272.0	$226.8	$179.1	$162.1
growth	3.9%	14.0%	8.4%	5.1%
Impact of Lower Pension Expense	$4.6	$5.3	$5.5	$5.9
Adjusted Non-GAAP Pretax Income	$267.4	$221.5	$173.6	$156.2
growth	2.2%	11.4%	5.1%	1.2%

Clearly, the lower pension expense has been a material contributor to recent non-GAAP growth rates, and it may be waning going forward.

Accounts Payable Are Still Skyrocketing

As we have noted in past reviews, like many companies in the food segment MKC is boosting cash flow by stretching its payment terms with suppliers.

Table 5

	11/30/2019	8/31/2019	5/31/2019	2/28/2019
Trade Accounts Payable	$847	$783	$707	$674
Trade Accounts Payable Days	90.2	91.3	81.9	79.3

	11/30/2018	8/31/2018	5/31/2018	2/28/2018
Trade Accounts Payable	$710	$646	$624	$584
Trade Accounts Payable Days	74.9	74.7	72.1	69.7

The company freely admits in its filings that it is receiving a boost to cash flow from “extending our payment terms to suppliers” and this has been going on for several quarters. The company does not itemize the cash flow impact of payables on its cash flow statement but our “back of the envelope” estimate from the change in balance sheet payables indicates the rise in payable days added about $70 million in incremental cash flow in fiscal 2019 or about half the reported growth in operating cash flow in the period.

Sales Allowances Down Along with Other Accrued Liabilities

At the time of the sale, MKC accrues for potential payments to customers in the form of trade discounts, rebates or returns. The company only discloses the balance of the accrued sales return liability on an annual basis, but it is worth noting that the allowance fell to $137.2 million at the end of 2019 from $142.1 million a year ago despite a slight increase to sales. This would have added about 3 cps to earnings over the course of the year. While not material when viewed over the whole year, the possibility exists that the entire impact could have fallen in a recent quarter and materially impacted the reported growth.

Likewise, the company disclosed in its 10-K that the “other” component of accrued liabilities declined to $287 million from $330 million, but we are uncertain as to the source of the decline. Nevertheless, a decline in accrued liabilities introduces the possibility that the company could have under-accrued for expenses to the benefit of earnings.

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 Concerns"	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 may 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 the next quarter. 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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