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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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Macy's Investor Day Update
Maintain BUY

We are maintaining our BUY recommendation on Macy's after its investor day presentation. There is a sizeable amount of addition by subtraction. The company held its dividend level and forecasts will cover it. The dividend is $1.51 per share against forecasts for 2019 EPS of $2.72-$2.77. By 2022, the forecast is $2.50-$3.00. While capital spending is expected to equal depreciation in 2020, it should eventually return to 50%-75% of that level which means EPS will be penalized by non-cash depreciation of about $250-$500 million or $0.60-$1.20. So, the dividend would be about 36%-49% of cash earnings. Also, the forecast is for $1 billion in free cash flow on a recurring basis against the $465 million dividend. The 9% dividend has been addressed in a positive manner in our view.

The company expects to save $1.5 billion in annual costs and believes that much of that will be reinvested back into the infrastructure of the business. Most of the savings appear likely to occur as they are based on obvious cost reductions such as cutting jobs, closing weak stores, and consolidating corporate overhead. Given that the company will remove lagging stores, it should help comp sales and expectations do not call for much growth setting up

Macy's for potential positive surprises. Also, more of the changes already in place that drive comp sales are now a larger part of the top line and should continue adding to comps. In our view, the stock should respond very favorably to positive comps – it was in the mid-$20s when it reported 7-straight positive growth comps. That should also help leverage the cost structure and leverage earnings gains. Guidance calls for negative comps in 2020 on a tough 1Q, but the dividend of nearly 9% should also limit much stock price decline as the growth path starts to build.

We are going to focus on the new plans and update existing plans that are being expanded:

- **Macy's plans to close 125 laggard stores in declining malls over 3-years. This is less than 10% of sales even though they are 14% of the store total.** They are posting weaker comps that run about 300bp below the other stores. The closings will be orderly as they are still cash flow positive – but Macy's expects their decay to accelerate.

- **Remaining real estate focus will be on continuing what is already working – more BackStage and more Growth prototype remodels. We consider that to be low-risk ways to improve comps in addition to subtracting laggard locations from the mix.** The remaining stores will get investment to handle more of e-commerce deliveries, pickups, and returns. Also, Macy's is planning to unlock more real estate cash flow and expects to continue generating $100 million in gains on asset sales for several years. The cash proceeds should exceed that.

- **Macy's expects $600 million in gross margin gains and $900 million in SG&A savings from the new plans announced this week and the September 2019 plan already in progress. It is forecasting $960 million in lost sales from closing the stores. And, it is not forecasting much margin gain because the bulk of savings will be reinvested into e-commerce and other customer programs.**

- **Guidance is for a poor 1Q20 that will improve throughout the year and through 2022. The long-term forecasts look conservative to us. The company is calling for minimal sales growth off the low and margins below 2017-18 levels. Beating by 1% on comp sales would give EPS a boost of about 22-cents. Beating by 50bp on margins would boost EPS by 29 cents.**

- **We see 10-reasons to expect sales growth to exceed forecasts.** Simply closing laggard stores that are posting comps 300bp below others and converting more locations to

Growth Models where comps are 400bp above others should be two reasons sales could surprise on the upside.

- **Margins could also surprise as lower profit areas are getting smaller and consolidating overhead costs should help margin gains.** The emphasis of areas that are higher margin is another area such as boosting the percentage of favorite brands (Coach, Chanel, Ralph Lauren, etc.) from 25% of sales to 30%. These tend to post 200bp higher margins already.

- **Vendor Direct continues to expand. This is where Macy's offers inventory held by suppliers that can be seen, ordered online, and either picked up at the store or shipped to a customer's home. This adds inventory (some of it exclusive to Macy's) and the company does not have to hold it.** That reduces mark-down risks and helps margin and it reduces inventory investment and produces cash flow. The forecast is to take $200 million in inventory out of the supply chain.

Basic Overview for 2022 Forecasts and Areas Where It Looks Conservative - Sales

Macy's is looking to achieve sales of $23.2-$23.9 billion in by 2022. That is below 2019's $24.5 billion. Simply closing the laggard stores is expected to cost Macy's $960 million in lost sales. Subtracting that from the $24.5 billion is basically $23.5 billion – at the midpoint of guidance. **Macy's is also forecasting Same-Store Sales comps of -0.5% - 0.5% in 2022. From 2019-22, the forecast is Same-Store Sales will be -1.0% to flat.**

Built into that forecast is 2020 will see $240 million of lost sales from the first batch of closed stores. Also, comps are forecast at -2.5% to -1.5% in 2020. Using a -2% comp and the loss of $240 million in sales would put 2020 at $23.8 billion. Subtracting the remaining $720 in lost sales from store closings after that would have sales bottom out at $23.1 billion.

We think there are several reasons why Macy's could beat these forecasts:

- **They are assuming that all the sales of closed stores will be lost.** In many cases, there are other Macy's nearby that could capture some of those sales. Also, some of those sales may move online.

- **The last two years, Macy's has suffered from weak international shopper numbers due to the strong dollar. This has impacted sales and comps at some of the larger stores.** International shoppers tend to spend more money per visit and they don't make many returns. There was no mention that Macy's is forecasting this to recover at all.

- **Sales comps should get a boost simply by taking the laggard stores out of the mix. Macy's says those stores are comping 300bp below other stores.** Any sales from closed stores that occur at remaining stores should also boost comps at the remaining stores. We call this reverse-cannibalization.

- **BackStage continues to be rolled out and will reach 274 stores at the end of 2020, which will be more than one-third of stores. There are solid stats that BackStage works. The Backstage units are comping at 5%. Macy's data shows that BackStage is adding 2% to the overall store's comp where it is located.** Also, they know what BackStage customers spend. The average one spends $502 per year at Macy's and makes 6.4 visits. The customer who only shops a Macy's store and doesn't use BackStage is spending $332 per year and makes 3.5 visits.

- **The Growth Store Model started out as 50 stores, became 150 last year, and will become 250 in 2020. That will also become one-third of the store base. They will also be 78% of total sales, up from 51% of sales in 2019.** The original 50 Growth Models have comps to examine and are comping 400bp higher than the rest of the store base.

- **They are cutting selling space devoted to kitchenware electronics. These are lower profit areas and are only 1.5% of total sales.** The demand tends to be heavily seasonal as well. Some of this space will be repurposed into products that sell better.

- **Online sales are $5 billion or 20% of total sales now. The CAGR from 2009-19 was 24% and is double the growth rate of other retailers' digital sales.** It posted a high single-digit comp for 2019. Macy's is increasing same-day delivery for online sales going forward.

- **Macy's has a strong loyalty program and finds that giving rewards known as Star Money on purchases keeps loyalty members shopping. They are increasing rewards going forward.**

- **Deals with Favorite Brand Vendors come with exclusive content for Macy's. People who argue that merchandise at Macy's is found on Amazon and 20 other places are not correct.** There are deals with vendors such as Clinique, Ralph Lauren, Coach, Chanel that give Macy's first launch of products and exclusivity on other SKUs. Macy's is planning to grow this area from 25% of sales to 30% so these types of deals could become larger and help Macy's sales growth.

Recent Comps are not down 2%. For 2019, the comp is -0.7% after a 2.0% comp in 2018. We know that 3Q19 had a tough comp and the company was reducing inventory – here are the last eight quarters for Same-Store Sales:

Sales Comps	4Q	3Q	2Q	1Q
2019	-0.5%	-3.5%	0.3%	0.7%
2018	0.7%	3.3%	0.5%	1.7%

When we look at this from a big picture perspective, Macy's is removing -3s and weak product lines from sales and adding more positive 2s, 4s, 5s, and 9s to the comp mix. And the positive figures are against a larger total percentage of sales. That just doesn't add up to -1% to flat in our view. Then there is still the possibility that remaining stores capture some of the sales from closed stores and at some point, the International shopping recovers off a low base and both of those events would help comps grow.

Macy's is calling for $2.50-$3.00 in EPS for 2022. We can see sales bottoming at $23.1 billion. Gross margin is expected to rise to be flat in 2019 and 2020 and then improve about 40bp by 2022. Let's use 39% - a 1% comp surprise at that margin would be worth about 22-cents in EPS.

Another area where sales could surprise to the upside is if Macy is successful in the plans to boost its third-tier customer base.

Customer	Advocates	Convinced	Occasional
Per capital Spend	$4,700	$1,700	n/a
# of visits per year	36	21	5
% of total sales	14%	20%	53%
% of total customers	1%	5%	54%

The first two groups have a 98% retention rate. Macy's has identified 5 million people in the third group that have characteristics of the first two. If they get 1 million of the 5 to spend an extra $200 per year – that would add 1% to the comp right there.

Basic Overview for 2022 Forecasts and Areas Where It Looks Conservative – Margins

The latest restructuring is calling to save money from reducing employees by closing stores and consolidating the corporate units. It will save other costs from closing 125 stores and will rework the supply chain. The overview is that the plans announced in September will be expanded. The latest deal will result in total gross profit improving by $600 million and SG&A falling by $900 million which includes the results of the September plan too.

Those savings and improvements would essentially boost gross margin by 255bp and operating margins by 635bp. However, much of that $1.5 billion will be recycled back into the business to roll out more BackStage and Growth Model units. It will be spent expanding the digital sales platforms, same-day delivery, revamping Ready To Wear for women and boosting jewelry offerings. They want to grow private label brands and boost favorite customer brands from 25% of total sales to 30%. A focus on boosting features to the loyalty program will also happen.

What is surprising to us is Macy's is not forecasting much of a margin increase as a result of all the changes. The 2022 forecast only calls for a 40bp increase in gross margin, EBITDA margin of 9.3%-9.9%, and operating margins of 5%-6%. That is not much different from what Macy's has done for years:

	2018	2017	2016
Gross Margin	39.1%	39.1%	39.5%
EBITDA Margin	11.5%	12.5%	11.5%
Operating Margin	5.9%	6.0%	6.3%

For 2019, the EBITDA margin was 11.5% - but we don't have the other numbers. The forecast is to hit 9.3% to 9.9% for EBITDA margin by 2022 with a higher gross margin. If the company beats on margins by only 50bp – it adds 29-cents to EPS forecasts.

We think the cost savings will largely be achieved and provide the funding for Macy's reinvestment:

- **About $400 million of the $600 million improvement in gross profit are from the September plan already reducing the cost structure.**

- **About $600 million of the $900 million in SG&A savings will come from easy to cut areas such as closing stores, closing duplicate corporate centers, and reducing employees related to those areas.**

- **The new loyalty program spending focus will be paid for by recycling current programs in that area already identified in the new spending.**

- **Other areas such as savings from private label brands and less discounting are tied to areas Macy's has considerable experience already** such as Vendor Direct where it grows SKUs without having to carry the inventory and vendors have already been working with Macy's on tariffs and now Macy's wants to boost orders from them.

- **Vendor Direct expansion should reduce inventory levels and mark-down risk.** By not holding inventory, Macy's boosts cash flow and is planning to pull $200 million out of inventory investment. Also, the risk of mark-downs should decline with lower inventory levels. That should help margins too. They are forecasting $20 million of gross profit improvement in 2020 and $100 million by 2022.

If Macy's will have $1.5 billion in annual cost savings to reinvest back in the business and the focus will be on expanding the strongest areas for sales and margins plus upgrading digital platforms, inventories, and loyalty programs – we believe those types of changes should have a positive impact on margins. The forecast that margins will be flat to down after all that seems overly conservative to us.

We think the favorite brands focus has positive potential for margins too. We mentioned above that this is about 25% of Macy's sales and the goal is to make it 30% of the total. These sales come with a margin about 200bp higher than the rest of sales. An incremental 5% of sales at an incremental 200bp of margin is worth 6-cents in EPS.

Property Deals Should Continue to Add to Cash Flow and EPS

Macy's highlighted that it expects to continue monetizing real estate as well. It expects to generate about $100 million in asset sale gains annually for several years to come. More importantly, the cash proceeds should exceed that $100 million figure. This gives further cash flow to sustain the dividend, reduce debt, and provide cushion for the reinvestment program.

These do not look overly optimistic at all. Much of these deals will involve selling parcels of land out of the parking lot that Macy's owns. These become banks or restaurants that attract higher traffic. It tends to earn $1-$3 million in gains on these transactions. There are 16 in progress and 40 more on the drawing board.

Other deals are larger scale and result in development of office space, hotels, and larger new real estate projects as part of a significant revitalization of a mall area. Macy's contributes the land to a JV and can take cash or remain an investor in the total deal. These are $100-$300 million projects and there are 16 in negotiation or pre-development and another 30 being considered.

Finally, large scale projects are also being discussed and moved forward. For example, the Herald Square flagship store in New York is adding 1.5 million sq. feet of office space above the store.

The focus for Macy's is does a property have more value as real estate or an operating store? That determines if the land around the store and the store itself can produce a higher return by monetizing the real estate. In some cases, Macy's plans to close a current store and open a smaller freestanding store such as a BackStage or Market by Macy's in a higher traffic area. The company is testing a few of these stores now. This would be one new area as it relates to real estate and will likely remain a small part of essentially relocating some closed stores. We again think these types of stores, although small would add to total sales and offset the full impact of lost sales from stores that will close.

Altria (MO) 4Q19 Update
Upgrade to NEUTRAL

We are moving MO to a Neutral rating after 4Q results – where it took its second $4+ billion write-down of JUUL within a year of purchasing it and cut forecasts. Much of what we have focused on as shortcomings for MO have proven to be problems that the company has now realized, and MO lowered its forecasts. We are moving this to Neutral at the moment – but do not see much evidence that the problems are over. However, the timing of additional catalysts is less clear (even as pressure grows) and MO may be able to get through a few quarters with only the inherent decay of its primary business to worry about. Plus, we think investors will cheer the roll-out of IQOS and think impairment charges are over for now. We were more than amused by several comments on the call and accounting issues and will discuss these:

- **Moving JUUL from Equity Method to Cost Minus Impairment method does not change how we viewed this investment from the start – but it could inflate MO's GAAP income.** Our view was that this investment was going cannibalize cigarettes where MO owned 100% of the transaction and it was essentially fully cash earnings. MO was trading cash earnings for a 35% stake in non-cash earnings as JUUL was not paying a dividend. Now, it will be certain to not recognize non-cash losses.

- **MO does not expect any cash flow from JUUL dividends for several years at this point and it has written off $8.6 billion of the $12.8 billion purchase price in a year.** It hasn't even cleared Anti-Trust review yet. We found several aspects of the JUUL accounting change curious given results and impairments not taken on other equity investments such as ABI and Cronos.

- **MO's debt load remains much higher after borrowing the money to buy the 35% stake in JUUL and this is impacting its share repurchase program that had been a big driver of EPS growth in the past.** We're always fascinated that stock repurchases continue to violate basic economics 101 – when the price of the stock falls – companies just don't want to buy more stock. MO did not boost its share authorization and is guiding to only $500 million in repurchases in 2020.

- **Decay continues at peak rates for cigarettes and faster than the industry. Yet, MO plans to simply boost prices again.** We are intrigued that only two years ago, MO was complaining that small increases in gas prices hurt cigarette volumes when decay was 2%-3%. Today, it is touting that cigarette price hikes can easily offset lost volumes and boosting the age for buying tobacco to 21 can be overcome as volume falls by 6%-7%. We still see IQOS rolling out as another bomb for volumes.

- **Offering customers both JUUL and cigarettes in 2019 is now considered confusing and ineffective cross-distribution** (after MO pulled out of much of the distribution agreement). Of course, **rolling out a new IQOS (heated tobacco) won't have any of these problems with the same distribution and sales network**. Just ask management.

- **We noticed that of the $600 million run rate in cost-cutting achieved at MO - $88 million came from cutting R&D and advertising, $54 million came from lower litigation costs, and its accrued liability for litigation fell $98 million (a mere $14 million) as litigation levels increased.**

JUUL as a Cost-Minus Investment Doesn't Change that MO Will Not Receive Cash Flow on the Deal for Some Time – But It Could Help MO's EPS

We always believed that the hidden destruction of the JUUL deal was MO would help distribute it and put on shelves with cigarettes making it easier to buy JUUL – (It is cheaper too). For every JUUL purchase instead of cigarettes – MO would receive a 35% stake in equity income from JUUL and lose a 100% stake in income from the higher-priced cigarettes. That alone seemed to point to lower earnings going forward unless JUUL was selling more than 3x the volume it was cannibalizing. JUUL said its experience-driven data shows that 50% of the smokers who purchase JUUL switch away from cigarettes within 90 days.

It was worse than that at the onset – JUUL would have a higher cost structure to deal with too. Profits per unit would be lower. MO admitted this would be producing non-cash income. In the 10-K for 2018, it expected "little to no cash earnings from Cronos or JUUL." In 1Q19, MO said this on their conference call:

> *"Then you asked a question about the five-year breakeven, and I think the way we calculated that; it was really taking the equity income we expect in five years tax affecting it and then dividing it by the overall investment in Juul. **<u>So, it is an equity</u>***

__income return, not a cash return,__ although obviously by that point, given the significant level of income, we would expect to have some dividends as well."

Much has changed in under a year. E-cigarettes lost the ability to sell flavors in many retailers and the purchase age was moved to 21. JUUL also faces many lawsuits related to lung diseases.

MO still owns 35% of JUUL, has board seats, and continues to work closely with JUUL in regard to FDA issues, regulatory/merger issues, and litigation issues. While they never expected to receive dividends from JUUL for several years, they did anticipate non-cash equity income would arrive. MO now reduced its 3-year EPS forecast because it has changed JUUL out of the equity method of accounting (adding pro-rata share of gains and losses) to MO's income:

From 4Q19 conference call:

"We don't currently expect to receive equity earnings contributions from JUUL over the next three years. Therefore, we've lowered our 2020 through 2022 compounded annual adjusted diluted EPS earnings growth objective to 4% to 7% from our previously announced objective of 5% to 8%."

It is also possible that MO anticipates some sizeable hits to JUUL's immediate income and thus changed to the cost-minus impairment approach even with the same 35% weighting and board representation. After writing off $8.6 billion of the $12.8 billion JUUL investment, MO will now carry the investment at cost minus any impairment charge. Thus, JUUL earnings will have no impact. **This accounting treatment will change again in the 2H of 2020.**

The transaction is still going through anti-trust review and MO expects that may be completed in the 1H of 2020. After that, the board will expand from 7 to 9 with MO having 3-seats. At that point, **MO expects to convert its accounting to the Fair Value method** where it will reflect any dividends received from JUUL as income and any changes in fair value of the investment that will be computed quarterly. Plus, any impairment – MO will call it out as a special item and adjust it out. So, only upside will be considered:

From the 4Q19 call:

"When you look at the fair value option, you have two components that come through. ***You only record, if you will, equity income related to dividends****. And then, you have, if you will, the change or adjustment to the fair value on a quarterly basis. And so,* ***since that equity line would include only dividends, we don't have any expectations that we would receive dividends over the next three years."***

We Also See Some Accounting Issues with Other Investments

MO also has a large investment in Anheuser-Busch Inbev that it accounts for under the equity method. As a result, it records its pro-rata share of ABI's income in its EPS. On the cash flow statement, it subtracts the non-cash income and adds in any dividends received. On the balance sheet, the income boosts the value of the investment and the dividend reduces it. MO also evaluates the carrying value of the investment against fair value to assess possible impairments.

ABI is publicly traded so it is easy to assess fair value. In 2019, the carrying value was $18.1 billion while the publicly traded value was only $16.1 billion. That was after a sizeable recovery in stock value during the year as in 2018 the public value was only $13.1 billion against a carrying value of $17.7 billion. MO did not book an impairment in either year – arguing that the decline in value was temporary.

We've talked about this in the past too. The reason ABI stock declined was the company had growth problems, had a leveraged balance sheet and was forced to cut its dividend and devote its focus to fixing the balance sheet over many years. MO now takes in only about half of its reported ABI income in cash. It still didn't report an impairment. PriceWaterhouseCoopers said it relied on significant judgement by management and a high degree of auditor judgement to evaluate the conclusion that the decline below carrying value could be justified as temporary.

Cronos is the marijuana company in Canada the MO purchased last year too. It was essentially a penny-stock and the company had $21 million in sales last year. It's $1.1 billion net profit was due to the increase in derivative instruments that rose after MO bought 45% of the company with an option to buy another 10% for a total price of $1.8 billion. This company is accounted for under the equity method too.

During 2019, the stock fell from $28.50 after MO's investment to under $10. As a result, MO saw the value of its warrant fall by $1.4 billion and it recorded that loss. For Cronos, the warrant's decline was a windfall profit and the net income from was $1.1 billion. MO reported its pro-rata share of that gain in income $496 million. The net was a loss for MO in 2019. We just find it peculiar to see huge loss flow back to the company as a gain at the same time for a company that obviously would have been in the red without MO's loss.

Cronos was also not considered impaired despite the huge drop in its stock and MO's warrant value. The fair value at the end of the year was $1.2 billion against MO's carrying value of $1.0 billion.

In both cases, we think there is a possibility of another impairment charge. Simply having Cronos at 36% of its peak value creates that risk.

MO Is Slowing Share Repurchases

We have talked before that the company has little free cash flow after the dividend to make share repurchases at this point:

	2019	2018	2017	2016	2015
CFO	$7,837	$8,391	$4,901	$3,821	$5,843
CapX	$246	$238	$199	$189	$229
Minor Acq	$421	$15	$415	$45	$0
FCF	$7,170	$8,138	$4,287	$3,587	$5,614
Dividend	$6,069	$5,415	$4,807	$4,512	$4,179
Repurchases	$845	$1,673	$2,917	$1,031	$554

Don't forget, tax reform added nearly $1 billion to MO's cash flow. Also, in 2018, the company picked up another $1 billion in cash from a steep drop in accrued settlements. This does not include the purchase of Cronos or JUUL.

The company has also gone from growing the total dividend at 7% to 12%. Share repurchases have dropped considerably in recent years too. That had been helping mitigate the total dividend growth. Almost annually, MO increases its remaining share repurchase program. At the end of 2019 – it did not. In July it authorized $1 billion in share repurchases and filled about $500 million of that figure. It only has $500 million more remaining. Historically, spending more than $2-$3 billion on shares was common. Now, it's $500 million.

Where is the cash coming from to think of increasing this? We simply don't see it happening. That will put pressure on dividend growth too. MO has also already leveraged its balance sheet to buy JUUL and Cronos for $14.7 billion. Debt is $28 billion and 2.3x EBITDA.

We always like to point out that MO was a huge buyer of shares at $70. It should love the bargain price of $45. But no, suddenly buying stock doesn't seem like a great use of cash.

The Decay in Cigarette Volumes Continues at Peak Levels

We have talked of this extensively too. MO used to deal with 2%-3% volume decline with price hikes. The company spoke how it needed to be wary of price increases because customers had to choose between paying higher gas prices of 5-10 cents per gallon and buying cigarettes. Now the decay rate runs at 6%-7% against comps of 5%-7% decay. MO is also losing young smokers to replace existing ones with the age to buy tobacco rising to 21. Almost no one starts smoking after age 21.

	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18	2Q18	1Q18
MO Volume	-6.0%	-7.0%	-7.0%	-7.0%	-5.5%	-5.0%	-5.0%	-7.0%
Industry Vol.	-4.5%	-5.5%	-6.0%	-5.0%	-5.0%	-4.5%	-3.5%	-5.5%

MO is losing more than the industry and 4Q saw JUUL floundering. This is their most profitable business unit and it plans to roll out heated tobacco (IQOS) and dissolving lozenges too (On!). We know from other markets that IQOS tends to gap down smoking volumes by over 20%. On top of that, we believe the age restrictions will help prevent new nicotine addictions. So, we expect serious decay to continue in volumes.

The company is proud of pointing out that it can raise prices and a 1% price hike only hurts volume by 0.3%. It's a net winner. Last year, operating income rose by $724 million based on price increases less volume losses – 8.6% growth. Yet, the company also cut operating costs on an annualized basis by $600 million. A great deal of the $724 million in our view came from that area and will be tough to duplicate.

In more detail, what we saw in cost-cutting was $88 million from lower R&D and advertising, $54 million in lower litigation costs, and a $98 million drop in litigation accruals. Try to repeat that. Litigation volume is rising with JUUL and MO is working with JUUL on that. It specifically cited litigation as a key part of the second write-down in JUUL's value in the 4Q. Their litigation accruals are only $14 million at this point.

On top of that, don't forget it borrowed $14.8 billion to buy JUUL and Cronos and has no cash flow coming in from those areas. The higher interest cost is running just under $600 million too. We simply are not seeing cigarette price hikes as being capable of offsetting all this if some of the discretionary costs in advertising and litigation do not continue to decline. And both will likely rise given litigation is increasing and MO wants to roll out new products.

Also, we were more than amused that how it would be easy to expand JUUL distribution last year according to MO. Put it on the same shelves as Marlboro, give customers a choice, advertise for it in Marlboro packs. After the second write-down in the JUUL investment, MO now says that duel distribution wasn't very effective:

Howard Willard on 4Q call:

> *"What we found was that having both JUUL personnel and Altria personnel that were sometimes involved in executing for JUUL at retail, that created confusion and that wasn't really an effective way to get the most out of the Altria sales organization. So, we ultimately agreed with JUUL that they'd continue to provide a number of services exclusively and that we'd pull back."*

So, it was confusing to offer cigarettes and e-cigarettes at the same time. But MO is going to roll out lozenges and heated tobacco at the same time going forward without confusion? They are only betting their cash cow on these roll-outs. Why should anyone be concerned? Plus, PM has demonstrated multiple times in several markets that heated tobacco crushes cigarette volumes.

Johnson Controls (JCI) EQ Update- 12/19 Quarter

Current EQ Rating*	Previous EQ Rating
3+	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are raising our earnings quality rating to 3+ (Minor Concern) from 3- (Minor Concern)

Our review of JCI's recent results turns up no major concerns regarding the company's earnings quality. The company has undergone a major transition over the last few years with the 2016 combination of Tyco International and Johnson Controls, Inc. This was followed by the late 2018 agreement to sell the Power Solutions business to Brookfield Capital. The resulting discontinued operations and held for sale disclosures, along with the related restructurings have all clouded visibility into reported results and therefore reduce the quality of reported earnings in our mind. Nevertheless, we do not see enough signs of significant earnings manipulation to warrant a "Weak" rating.

We do note the following minor concerns with the quarter.

- Pension and postretirement benefit cost fell by about a penny per share in the 12/19 quarter driven mostly by lower interest cost likely due to a higher discount rate used in the calculation. This is a relatively small boost and will probably not reverse until a lower discount rate is utilized next year.

- The company capitalizes costs to obtain contracts and amortizes them over the contract term. We note that while the capitalized balance has increased sequentially for the last five quarters, year-over-year amortization of contract costs fell by $9 million in the 12/19 quarter versus a year ago. This added about a penny per share to EPS growth.

- The quarter contained $111 million in restructuring charges and impairments related to the recently announced "2020 Plan." This follows the 2018 Plan which involved $255 million of restructuring and impairment costs, and the 2017 Plan with $347 million in costs. The size of the restructurings is shrinking and the magnitude of relatively recent business combinations and divestitures gives some level of leeway for the presence of charges. We also note that about half the 2020 charge was earmarked specifically as severance related and the other half for asset impairments with only $3 million allocated as "other" which reduces our concern somewhat. Regardless, the 2020 Plan's $111 million price tag represents a little over 6% of fiscal 2019's adjusted income from continuing operations. Such large, recurring charges will always reduce the perceived earnings quality in our mind given the possibility that material ongoing expenses have been lumped into the charge and "written off".

- JCI began an aggressive share repurchase program after the late 2018 announcement of the sale of the Power Solutions business. The company received cash proceeds from the finalization of its sale in the 6/19 quarter to pay down debt but also make an additional $4 billion buyback in the 6/19 quarter with over $850 million and $650 million in additional installments made in the 9/19 and 12/19 quarters, respectively. As a result, the weighted average diluted share count was down by 16% year-over-year in the 12/19 quarter. This is a sizeable boost to reported earnings per share growth that will not begin to fade until after the 6/20 quarter.

Boeing (BA) EQ Update- 12/19 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*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)

Our review of the 12/19 10-K did not turn up any new items of concern, but we do note that the progress of amortization of deferred 787 production costs took a turn for the worse in the quarter.

- From an accounting perspective, our focus has been on the 787 deferred production cost balance. This account contains initial 787 setup costs but more importantly, all losses and below-forecast profits for the first few hundred 787s built during the program run. Once profit per plane began to top the average estimated profit for the program, the deferred costs were then amortized back into earnings to the extent profit per plane exceeded the average program forecast. Huge cost overruns from initial complications with the plane left a huge deferred cost balance and questions as to whether BA would eventually have to write off a meaningful part of the balance.

- We noted in our review of the 9/19 quarter that the amortization of the deferred costs per plane for deliveries in the quarter was large enough for the company to fully amortize the balance by the end of the current accounting quantity. However, we estimate amortized deferred loss per delivery in the 12/19 quarter fell to about $27.4 million which is below the $31.5 million necessary to fully amortize the balance over the remaining accounting quantity.

- We also noted in our last review that the company reduced its planned production rate for the 787 to 12 per month from the 14 per month it had just established at the end of the 3/19 quarter. The disclosure in the 9/19 10-Q indicated the lower production rate would begin in late 2020 and continue for two years. However, new disclosure in the 10-K states: **"As a result of fewer orders than anticipated, we plan to reduce the 787 production rate to 12 per month in late 2020 and to 10 per month in early 2021**. We plan to return to a production rate of 12 per month in 2023." Any indication of lower than anticipated demand increases the possibility the company will not be able to sell enough 787s at high enough profit margins to work off the deferred cost balance.

Amortization of Deferred Production per Plane Falls Below Required Pace

We refer clients to our original 12/19/19 and 9/5/19 reviews for a complete primer on the mechanics of BA's program accounting. For a quick review, the program accounting method requires the company to make assumptions regarding the eventual number of planes produced, average prices realized, and average costs per plane. From this, the company calculates and average profit per plane. In the early parts of the run, profit per plane will fall below the average estimated profit and the shortfall is capitalized in "deferred production costs" as a component of inventory. Later in the production run when profit per plane rises above the estimated average, the deferred costs are amortized against earnings in the amount of the excess. To avoid a charge, the company must sell the targeted amount of aircraft (the accounting quantity) at a high enough profit to fully amortize the deferred costs.

The following table shows the progress of the deferred production cost balance and the calculation of the amortization per plane delivered in the 12/19 quarter:

	12/31/2019	09/30/2019	06/30/2019	03/31/2019
787 Deferred Production Costs	$18,716	$19,825	$20,969	$22,029
787 Unamortized Tooling and Other Non-Recurring Costs	$2,092	$2,215	$2,354	$2,532
Total 787 Deferred Production Costs	$20,808	$22,040	$23,323	$24,561
787 Deliveries	45	35	42	36
787 Cumulative Deliveries	939	894	859	817
787 Program Accounting Quantities	1,600	1,600	1,600	1,600
787 Undelivered Under Firm Orders	520	529	555	596
787 Cumulative Firm Orders	1,459	1,423	1,414	1,413
Change in Deferred Production Costs	-$1,232	-$1,283	-$1,238	-$1,044
Per Delivery	-$27.38	-$36.66	-$29.48	-$29.00

In our review of the 9/19 quarter, we noted that the decline in the deferred production cost account per plane delivered in the quarter of $36.7 million was above the deferred production cost balance per remaining planes on the accounting quantity of $31.3 million. This implied that if BA was able to sell the number of planes left on the accounting quantity at the same profit level it realized in the 9/19 quarter, it would more than work off the deferred production cost balance thus negating the need for a write-down.

However, conditions appear to have worsened in the 12/19 quarter as the change in deferred costs per plane delivered fell to $27.4 million which is well below the required pace to eliminate the deferred cost balance by 1,600 deliveries (the accounting quantity.)

787 Production Rate Lowered Further

Another item that raises our concern is the company noting in the 10-K that it is lowering its planned 787 production rate for the second time in six months. We noted in our review of the 9/19 quarter that the company reduced its planned 787 production rate given deteriorating market conditions after raising the production rate just three months earlier. The 9/19 10-Q stated:

> *"At the end of the first quarter of 2019, we increased the production rate from 12 per month to 14 per month. We delivered the first 787-10 in March 2018. Continued global trade tension has resulted in market uncertainties and fewer*

> *orders than anticipated.* ***During the third quarter of 2019, we decided to reduce the 787 production rate to 12 per month for approximately two years beginning in late 2020."***

However, just three months later, the company announced it was lowering the planned production rate even further with the 12/19 10-K stating:

> *"At the end of the first quarter of 2019, we increased the production rate from 12 per month to 14 per month.* ***As a result of fewer orders than anticipated, we plan to reduce the 787 production rate to 12 per month in late 2020 and to 10 per month in early 2021.*** *We plan to return to a production rate of 12 per month in 2023."*

Declines in the production rate do not bode well for the company's ability to avoid a write-down of the deferred production cost balance as it indicates conditions may not be conducive to selling an adequate number of 787s to cover the accounting quantity and realize high enough profits per plane to work off the balance. In addition, lower production rates imply less efficient production which puts pressure on profits per plane.

Going forward, investors should continue to monitor the reduction in deferred cost balance per delivery as well as more signs of weakness in 787 demand.

Lancaster Colony (LANC) EQ Update- 12/19 Quarter

Current EQ Rating*	Previous EQ Rating
3+	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are raising our earnings quality rating to 3+ (Minor Concern) from 3- (Minor Concern)

We note that retail sales were flat in the quarter, growth has been dependent on price increases which are difficult to sustain in the packaged food industry, and the valuation of 28 times forward EPS seems pricey. Nevertheless, from the standpoint of earning quality, the quarter was relatively clean.

- LANC is somewhat unique in its practice of not reporting a non-GAAP reconciliation breakout in its press releases and stops short of actually giving a "company approved" adjusted EPS figure. Instead, the company discusses any unusual impacts on profits and leaves it to the investor to sort it out. While we applaud the company for not abusing the non-GAAP practice to add back potentially operational expenses to an adjusted number, this can leave the headline EPS numbers misleading. Case in point, the 6/19 quarter's benefit from an approximate $7 million gain from the downward adjustment to the estimated liability of contingent consideration from its Angelic Bakery acquisition. (While perfectly in-line with GAAP and accounting theory, it's an interesting concept to book a gain because a company you bought is performing poorly.) However, the company completely wrote off the value of contingent consideration in the 6/19 quarter. At this point, results may still be impacted from changes in contingent consideration related to the Bantam Bagels deal which was valued at $9 million as of the end of the 12/10 quarter. Recent changes for that liability have been immaterial.

- Lower stock-based compensation added 1.2 cps to earnings in the quarter. This expense can be volatile over time and the benefit was due to this year's quarter being slightly lower than trend and last year's quarter being slightly higher. This is the first meaningful contribution to earnings growth in several quarters from a change in the timing of stock-based compensation, but we view this as a minor concern as it was not a material factor in the earnings beat in the period.

- As we have noted in past reviews, capital spending has spiked as the company invests in capacity expansion at its dinner roll plant. Quarterly capex returned to normal levels in the 12/19 period which will provide a tailwind to free cash flow growth over the next few quarters.

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.

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