BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Sealed Air (SEE) 4Q Update
Downgrade to SELL

We are lowering our rating on SEE to a SELL again after 4Q results. The company beat by 3-cents on adjusted EPS. It had forecast that the benefits of higher price/cost spread would mitigate in 4Q and it still produced 8-cents in EPS for the 4Q. For the year, adjusted EPS rose by 32-cents and 39-cents came from price/cost spread benefits. SEE's contracts on pricing are tied to trailing commodity costs and there are periods where pricing exceeds cost inflation and periods when that reverses. The key is this trend evens out. Pricing taken above costs resulted in a windfall profit of $18 million pretax in 4Q and $83 million for 2019. That alone generated all the EPS and EBITDA growth for the year and SEE is forecasting a $70 million headwind in this area for 2020 – with a large part in the first half.

On top of that, SEE is not posting organic growth anywhere but South America, which we continue to rate as poor quality growth given the inflation-driven pricing and huge FX losses skew the results. Forecasts for 2020 call for SEE to outperform end markets

in food – something the company rarely does – and for overall negative organic growth. The company picked up 4-cents in EPS in 2019 due to acquisitions too.

The company noted that customers are destocking inventory and China offers challenges. Share repurchases helped EPS growth in 2019 by 9-cents of the 32-cent gain – the forecast is for the share count to have a slight uptick in 2020. There was no mention of the status of the $1.49 billion tax dispute or the SEC investigation. We will need the 10-K to review those items.

- **SEE is seen as a way to play fast-growth markets such as e-commerce and fresh protein demand worldwide. Yet, except for North America in 2017 – volume growth trails end markets and is softening.**

- **Without acquisitions, SEE is forecasting negative growth in 2020. Forecasts also call for its food operations to grow at 2% in a flat market.**

- The only place SEE is growing is South America. Hyperinflation is driving organic growth via pricing, but FX losses offset all those price gains. **Organic growth for SEE goes from 0% to -1.4% in 2019 without South America and from -1.6% to -3.2% in 4Q19.**

- **Restructuring is not driving EPS growth – it is only offsetting higher operating costs and FX losses. In 2019, restructuring savings came in at $66 million – while higher costs and FX losses were $64 million.**

- **The Price/Cost spread of recovering commodity inflation added 173bp to EBITDA margins in 2019 and $83 million to earnings growth. That is how the company beat forecasts throughout 2019 and that is set to reverse in 2020.**

- Adjusted EBITDA and sales growth are key metrics at SEE as they determine management pay and incentives. **The price/cost spread is not something being adjusted for in these metrics nor is South America or acquisitions.**

- **Adjusted EBITDA does add back some FX losses for exposure to inflationary currencies – that was 2-cents in 2019. It also adds back 3rd party consulting fees and legal fees that were up considerably in 2019 – a 31-cent bump in EPS. By adding back interest, depreciation, restructuring, and amortization – is there any acquisition that doesn't make sense?**

- The company's working capital generated cash in 4Q, but we would need to review the 10-K for more detail. **SEE has a securitization facility that results in receivables moving to prepaid expenses and those two line items had large moves in the quarter.**

We Continue to Be Amazed at the Lack of Growth at SEE

People own this stock because it is a way to play: 1) the growing demand for more protein, 2) the growing demand for fresh/not frozen food, 3) growth in e-commerce packaging, 4) growth in cost-saving methods for e-shippers, and 5) eco-friendly/recycled packing methods. Despite those tailwinds – SEE does not see volume growth at the same rates as its end markets.

From 2015, there has been one year when SEE posted strong volume figures – that was in 2017.

	2020e	2019	2018	2017	2016	2015
Food Volume	2.0%	1.0%	2.2%	3.8%	0.9%	1.3%
Prod. Care Vol.	neg	-3.9%	0.3%	5.7%	1.4%	-1.9%

In 2017, North America drove the boat with 7.2% volume growth due to higher economic growth, an increase in e-commerce, and an increase in protein packaging. That was also off easy comps. After two more years of easy comps, forecasts do not call for a recovery in 2020.

In 2019, the company blamed weakness on China buying frozen protein instead of fresh. Starting this year, China growth is slowing with Coronavirus. Plus, if they boost demand again after the virus pause – will they boost heavily or will they be picky? Does that also mean they continue to buy frozen beef which offsets fresh beef and does not benefit SEE? Or do they buy any protein available – chicken, pork, fish, beef – frozen or fresh? We'd think the Chinese will not be driving SEE's market in 2020. On product care, SEE is blaming customers destocking inventory and weak industrial manufacturing. The company is not forecasting a turnaround in early 2020.

Despite not exceeding the growth of end markets, SEE is expecting 2% growth for the Food unit against what it forecasts as a flat market for 2020. That could be an area of disappointment this year. The first question on the conference call pointed this out as well. The company expects its forecast to be very choppy quarter to quarter. The US dollar is still strong and that hurts too on competitiveness. Without that forecast, organic growth will likely be negative overall.

Acquisitions are a larger part of growth too. The guidance for 2020 is that Product Care will be driven by 7-months of apples-to-oranges comps from 2019's acquisition. Organic growth is expected to be -2%.

Total Growth	2019	2018	2017	2016	2015
Volume	-0.9%	1.5%	4.5%	0.6%	0.5%
Price	0.9%	3.0%	0.2%	0.6%	2.3%
Acquisitions	4.1%	2.6%	0.6%	-1.4%	-2.2%
FX	-2.9%	-1.0%	0.7%	-3.4%	-9.9%

Without acquisitions, there was no growth in 2019. It also added $14 million to EBITDA for the year. SEE does not adjust that out of EPS or EBITDA as a special item. Given that depreciation is about 3% of sales ($6 million against acquired sales of $195 million) and the tax rate was 26.4% - ($2.1 million on EBIT of $8 million), we estimate that acquisitions added 4-cents to EPS in 2019. It sounds that in 2020, with 7-months of apples-to-oranges comps – the impact could be slightly higher.

To Make It Worse, South America (5% of sales) Is Materially Driving Results before FX of Course

We have written about this several times in the past, but it is incredible to us that South America is actually making volume change only -0.9% instead of -1.2% in 2019 and -1.7% vs -2.4% for 4Q19.

	2019	South Am	Adj 2019	4Q19	South Am	Adj 4Q19
2018 total	$4,732.7	$229.5	$4,503.2	$1,260.3	$59.4	$1,200.9
Price	$42.5	$49.4	-$6.9	$1.0	$10.9	-$9.9
Volume	-$41.9	$11.6	-$53.5	-$21.6	$7.3	-$28.9
Price Growth	0.9%	21.5%	-0.2%	0.1%	18.4%	-0.8%
Vol. Growth	-0.9%	5.1%	-1.2%	-1.7%	12.3%	-2.4%

The recent surge in volumes from South America is coming from higher packing of beef rather than not packaging. We believe it was also helped by China buying more from South America than the US last year and we see some of that reversing.

The standard issue we have with companies touting South America is definitely in place too – the FX losses crush the pricing gains that are boosting organic growth. Organic growth is defined as changes in volume and pricing without FX. In 4Q19, every other geographic unit at SEE was negative on pricing and volume. For 2019, every other geographic unit was negative on pricing and volume except a mere $1.0 million gain on EMEA pricing. How realistic is the organic growth? You can see this above, organic growth goes from 0% to -1.4% without South America for 2019. For 4Q19, -1.6% reported growth goes to -3.2%.

Did we mention that South America is only 5% of sales? Adjusting for FX blows up the growth story for South America. Organic growth from 2019 sinks from 26.6% shown above to 1.8% in with FX impacts.

2019 Growth	N. Am	EMEA	S. Am	APAC	Total	Adj w/o S. Am
Price	-$7.3	$1.0	$49.4	-$0.6	$42.5	-$6.9
Volume	-$42.8	-$3.8	$11.6	-$6.9	-$41.9	-$53.5
FX	-$4.2	-$49.4	-$56.9	-$26.7	-$137.2	-$80.3
Total Growth	-$54.3	-$52.2	$4.1	-$34.2	-$136.6	-$140.7
Y/Y growth	-2.0%	-5.0%	1.8%	-4.7%	-2.9%	-3.1%

4Q19 Growth	N. Am	EMEA	S. Am	APAC	Total	Adj w/o S. Am
Price	-$7.5	-$1.2	$10.9	-$1.2	$1.0	-$9.9
Volume	-$27.2	-$1.6	$7.3	-$0.1	-$21.6	-$28.9
FX	$1.2	-$4.0	-$13.2	-$2.8	-$18.8	-$5.6
Total Growth	-$33.5	-$6.8	$5.0	-$4.1	-$39.4	-$44.4
Y/Y growth	-4.6%	-2.5%	8.4%	-2.1%	-3.1%	-3.7%

The Price/Cost Spread Helped 2019 Earnings– It Is Not Expected to Help 2020

We have been talking in prior reports about how SEE has benefited of late by taking higher price increases than its commodity inflation justifies. The company notes that its deals with customers are linked to commodity prices for raw materials such as resin and that in the long-run, cost-driven commodity price-hikes tend to even out and match the actual changes in costs.

For 2020, SEE is forecasting negative price/cost spread squeezing its EBITDA forecast. Jim Sullivan, the CFO put it this way:

> *"And then we talked about negative price/cost spread in Food Care in particular, driven by the formulas. So keep in mind,* ***the formulas are driven off of the resin profile that the company experienced in 2019. And those will be passed – some of those gains in 2019 will be passed through these formulas as we talked about, mostly in the first half of 2020.*** *So together between inflation and, call it, net price/cost spread, that's about, let's call it, $70-ish million."*

A $70 million EBITDA squeeze in 2020 in this area would be about 33-cents in EPS. How much did SEE pick-up from price/cost spread in 2019? The answer is $83 million and it was fairly even through the year:

	4Q19	3Q19	2Q19	1Q19
P/C Spread	$18	$24	$19	$22

This has no depreciation or interest expense; the tax rate was 26.4% so this was 39-cents of EPS in 2019. For all the reports of growth and gaining traction in South America and cost savings – adjusted EPS for SEE was $2.82 in 2019. That adds back all the restructuring and one-time items. Compared to 2018, EPS was up 32-cents. Here's 39-cents of that growth from nothing the company did – and it's about to fully reverse in 2020. Forecasts are for adjusted EPS to rise to only $2.85-$2.95.

Adjusted EBITDA rose in 2019 from $889.5 million to $964.8 million or 8.5%. Without the P/C windfall, Adjusted EBITDA would have declined by 0.9%. During the year, the company touted its prowess in cutting costs and the headline is that the

Reinvent SEE program drove 2019 results. SEE reported EBITDA margins rose by 130bp due to cost-cutting. In reality, Price/Cost added 173bp and the restructuring savings of $66 million basically offset higher operating costs and FX losses of $64 million.

We Think Investors Should Look at How Management Gets Paid

In addition to salaries, management gets a 50% bonus based on hitting targets for adjusted EBITDA and a 30% bonus for improving Adjusted EBITDA margins. On long-term incentives, 33% is tied to Adjusted EBITDA margins and 33% is tied to hitting 3-year CAGR targets on sales growth.

We don't have the 2020 proxy yet, but we see several areas where these items can be boosted:

- Adjusted EBITDA does not back out Price/Cost spread swings.
- Total Sales benefitted by $43 million last year due to price increases and may have been largely tied to the Price/Cost spread issues.
- Neither measure backs out acquisitions – as noted above, this added $195 million to sales and $14 million to EBITDA.
- Is there much disincentive to making any acquisition? There is no penalty for interest on debt, no penalty for increased amortization, no penalty for restructuring costs and anything purchased with sales, and EBITDA will add to those target figures.
- The Adjustments include adding back some of the FX losses due to highly inflationary economies. In 2019, this was $4.6 million. That is 2-cents in higher EPS as well.
- Restructuring charges for severance, consolidation, writing off assets – are of course added back. However, SEE is also adding back fees paid to third-party consultants and third-party legal fees relating to the restructuring. These

charges increased significantly in 2019 – from $23.3 million in 2018 to $89.4 million. The actual restructuring charges went down and were less than half that figure at $41.9 million. We are skeptical that all of that $89.4 million in consultants is related to one-time restructuring actions. If that total isn't added back – growth in EBITDA slows to 1.0%. Adding back the bump of $66.1 million y/y for consultants also boosted EPS by 31-cents.

- South America was also the only area of the company that reported any growth at all.

Working Capital Looks Better, but That Is Debatable

Management also has a 20% bonus incentive tied to improving the working capital/sales ratio. The company talks about looking for ways to pull working capital down. On the surface, this looks like it is happening:

	4Q19	3Q19	4Q18
Accts Rec	$556.5	$449.0	$473.4
Inventory	$570.3	$618.3	$544.9
Prepaid Exp.	$61.7	$201.4	$125.1
Accts Pay	$738.5	$712.7	$765.0
Other Curr. Liab.	$514.8	$482.4	$428.9

Liabilities increasing added $58.2 million in cash from September. Asset accounts declined and added $80.2 million in cash since September too. We would need the 10-K to review this more closely, but our concerns are:

1. Is inventory down because raw material costs have fallen and SEE has customers destocking? We don't consider raw material declines to be something SEE controls.

2. The company has a securitization facility for Accounts Receivable. It effectively moves receivables out of the A/R line on the balance sheet to puts them into prepaid expenses. When both those line-items show big movement, that is likely the cause, but we don't know what the current numbers are from the press release.

Ares Capital Corp. (ARCC) - 4Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on ARCC after a continuation of the same issues from 3Q and a yield of 8.4%. The $10 million per quarter management fee waiver is over and that cost ARCC about 2.3 cents in 4Q19 vs 4Q18 and is largely why core earnings declined from 48-cents to 45-cents.

There are pluses and minuses here. **We still believe that boosting the total Debt/Equity ratio over 1.0x will drive EPS higher and in turn, cause the dividend to increase.** Essentially, the ratio is 0.95x and every $400 million increase in the portfolio funded entirely with debt boosts that ratio by 5bp.

ARCC is earning about 9.6% on investments and paying 4.5% in interest for a spread of 5.1%. Every $400 million increase in the portfolio then generates about $5.1 million per quarter and management fees will lower that to about $3.5-$4.0 million. **That is 0.8-0.9 cents per quarter in EPS for every $400 million increase and the goal is to move closer to 1.25x from 0.95x.** We think conservatively, ARCC could see about 2-3 cents per quarter in higher EPS before the end of 2020.

Here are the current issues:

Falling LIBOR – It fell 74bp through 2019 and 78% of the investments are floating rate. Here are the pluses and minuses:

- Plus – the bulk of these investments have a 1.1% floor in place and if Libor continues to fall, eventually funding costs will decline more than investment income.
- Plus – New investments are seeing higher floors of 1.3% and some existing loans are being reworked to raise the floor too.
- Plus – If Libor does increase – ARCC has a built-in hedge against rising rates as some of its financing is fixed and the investment income will rise.
- Minus - Libor would still need to decline further to hit the floors so declining rates are still pressuring yields.
- Minus – the current decline has already cost ARCC about 1-2 cents per share in EPS in 3Q19 and 4Q19.

Dividends – The company has to distribute 90% of its income and can avoid excise taxes by distributing 98% of ordinary income and 98% of capital gains:

- Plus – ARCC covers its 40-cent quarterly dividend now with core earnings of 45-cents.
- Plus – It has 95-cents per share of spillover income that grew from 80-cents at the end of 2018. That represents additional income that will likely need to be paid out as dividends.
- Plus – ARCC has a history of paying supplemental dividends as well as boosting the dividend. The regular dividend has grown by 2-cents per quarter recently and the company paid 2-cent additional dividends each quarter of 2019.
- Minus – ARCC is watching the Libor situation for it to turn up before announcing more additional dividends.
- Minus – 2020 may see smaller total additional dividends than 2019 and any that are announced could be backloaded.

How Fast Can the Portfolio Grow and Produce Higher EPS?

- Plus – ARCC is the largest player in this group and has the longest tenure. That allows it to look at larger deals and it also means that it has experience with many of its portfolio companies going back many years. Current portfolio companies are over half of new investments.
- Plus – The company sees a larger pipeline of potential investments and that continues to grow. Current companies continue to see growth in EBITDA y/y of 3%-4% in most quarters.
- Plus – ARCC is picky and only closes about 4% of the investments it looks at.
- Minus – Being picky means ARCC doesn't plan to ramp up the portfolio size in a hurry. The goal was to get closer to 1.25x over 3-years and management admits they are behind plan at 0.95x at the end of 2019.
- Minus – Competition in the BDC space has grown too and those other companies are also boosting leverage. ARCC has noted in several recent quarters that there more deals being done with lighter covenants and tighter pricing. ARCC continues to focus on better quality and passes on those more aggressive loans.
- Minus- Being the largest means ARCC needs more investments to grow the portfolio meaningfully vs. some of the smaller competitors.

Without trying to time this quarter to quarter – we see that investors are getting paid 8.4% to wait for more of this play out after the first year of rising leverage and dividend growth. Bottoming Libor should start to reverse the earnings headwind of falling rates and start to grow EPS at a faster rate – or floors should eventually help too. EPS should also grow via the longer-term plan to boost the leverage ratio. There is a sizeable amount of excess earnings that will need to be distributed too. With three ways to grow the yield, getting this to a 10% yield would only require about 8-cents in additional dividends per quarter. Libor reversing to the start of 2019 is 1-2 cents, boosting the leverage for the portfolio to 1.1-1.15x equity would add about 2-3 cents as well, and 90-cents of undistributed EPS is 3-cents per quarter for 7.5 years.

Grubhub (GRUB) EQ Update 12/19 Qtr

Current EQ Rating*	Previous EQ Rating
2-	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 cutting our earnings quality rating to a 2- (Weak) and expecting more negative issues

After 4Q results, several signs at GRUB worsened and guidance isn't much better. Adjusted EBITDA which adds back stock compensation is forecast at $15-$25 million for 1Q20 vs. $51 million in 1Q19 and >$100 million for 2020 vs. $186 million in 2019. That's worse than it sounds as 2019 results declined from 2018. Here are some other concerns in our view:

- **With negative operating income in 2019 and guidance for that to weaken in 2020 – ROI should be a negative figure for both years too. Goodwill and Intangible Assets are essentially 100% of equity value and 64% of total assets.** With negative operating income and declining cash flow from operations plus the stock price about 35% of its peak – there are **many signs pointing to a potential impairment of these assets.** Investors should remember that GRUB had positive operating income in 2016-18 with only a modest drop in 2018. From a cash flow standpoint, there are pressures there as well and cash flow is already declining too.

- **Profitability per transaction and Volume growth (DAG – Daily Average Grub) have plummeted and it happened fast.** The company reports profitability per

transaction on adjusted EBITDA, which adds back stock compensation to boost that figure.

Adj. EBITDA/Order	4Q19	3Q19	2Q19	1Q19
2019	$0.58	$1.28	$1.24	$1.09
2018	$0.98	$1.57	$1.78	$1.63
2017	$1.60	$1.54	$1.46	$1.45

Y/Y DAG Growth	4Q19	3Q19	2Q19	1Q19
2019	8%	10%	16%	19%
2018	19%	37%	35%	35%
2017	34%	14%	16%	21%

The 8% volume growth in 4Q was helped 150bp by weather driving demand for deliveries. The company is only forecasting that it will be stronger than 6% for 2020. Adjusted EBITDA/Order will likely rise above a dollar again for some quarters in 2020 – but, may still decline y/y again.

- **Grubhub's profitability contraction is not coming from signing up more QSRs (Quick Service Restaurants like Taco Bell and McDonalds). The company illustrated that is not profitable on those orders and signs them up to please diners** who want the most options. Partnered Independent Restaurants generate more revenue to GRUB per transaction, a higher commission rate, and more profit per delivery ($4 per order) than non-partnered restaurants where profit is $1 and QSRs at $0. **GRUB made a point of saying in 4Q results that it launched 5 new Partnered and Small Chain locations for every QSR location of late.** That is reflected in the commission rate to gross sales ratio rising y/y again:

Commission Rate	4Q19	3Q19	2Q19	1Q19
2019	22.0%	23.0%	22.3%	21.6%
2018	20.9%	20.4%	19.6%	18.7%

- **4Q showed evidence that customers may be demanding faster payment from GRUB. Food payables were essentially flat sequentially on higher gross sales. DSOs on those payables dropped under 10 days.**

DSOs on Food	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18	2Q18	1Q18
Gross Sales	$1,552	$1,400	$1,459	$1,502	$1,377	$1,214	$1,220	$1,245
Commissions	$341	$322	$325	$324	$288	$247	$240	$233
Net to Restaurants	$1,211	$1,078	$1,134	$1,178	$1,089	$967	$980	$1,012
Food Payables	$132	$131	$124	$140	$127	$123	$110	$127
DSOs	9.9	11.1	10.0	10.9	10.7	11.6	10.2	11.4

Customers get paid on credit card receipts the next day (or after a Sunday or holiday). With Grubhub, they get paid 10-11 days later. We see a risk that competition drives this figure down and hurts GRUB's cash flow. This source of cash flow with double-digit growth in sales and rising commission rates was only $4.4 million of GRUB's $183 million in cash flow. Guidance is for slower volume growth, revenue growth that may slow to as low as 7%. **What happens if the DSOs drop 4-5 days? Suddenly, cash from operations may have a $60-$70 million negative swing.**

- **Cash Flow and EBITDA also rely on paying wages in stock compensation. The company is giving guidance for lower results and higher spending to obtain lower volume customers.** Marketing will continue to rise – it was 23.6% of sales in 2019 vs. 21-22% in prior years. **How much longer will employees want GRUB stock?** In 2018, options were issued with exercise prices at $63 and RSUs at $94. In 2019, options had a strike of $77 and RSUs at $74. The employees have seen the stock price fall 65% - even after the recent recovery. Many of their options remain out of the money.

	2019	2018
Stock Comp	$72.9	$55.3
CFO	$182.6	$225.5
Stock Comp %	40%	25%
EBITDA	$109.2	$170.9
Adj. EBITDA	$186.2	$233.7
Stock Comp %	39%	24%

To us, it appears that GRUB has risks of seeing cash flow decline by over 30% from customers and competition speeding up payments and as much as another 40% if employees want to be paid in cash if the stock price continues to languish below their strike prices. A potential impairment of goodwill and intangibles seems likely

Becton, Dickinson & Co. (BDX) EQ Update- 12/19 Quarter

Current EQ Rating*	Previous EQ Rating
3-	4-

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 lowering our earnings quality rating to 3- (Minor Concern) from 4- (Acceptable)

BDX reported non-GAAP EPS of $2.65 in the 12/19 quarter which was 2 cps ahead of the consensus with revenue also topping estimates. Note that the YOY 2% decline in non-GAAP was due to the expiration of a royalty and a tough comp from an 11.2% tax rate in the year-ago quarter.

Despite the earnings beat, the stock price was hammered due to the company reporting that it will take longer than expected to resolve issues with the FDA over its *Alaris* pump. The lost revenue and higher cost led management to lower its fiscal 2020 (ended Sept.) estimates for revenue growth to 1.5% to 2.5% compared to the consensus estimates of 4.0% to 4.5%.

Note that our reduced rating is a result of one-time benefits to the 12/19 quarter and in no way reflects the situation with the *Alaris* pump or the lowered guidance.

- DSOs based on balance sheet receivables fell by 4.5 days YOY in the 12/19 quarter. However, after adding back $328 million in factored receivables that were removed from the company's balance sheet, DSOs rose by 3.3 days. BDX has disclosed in the past that it can factor receivables as a way of managing working capital, but it has not quantified the impact in the last several quarters as it was immaterial to results. DSOs typically track very steadily at

BDX and the sudden jump in the adjusted 12/19 figure could be an indication that sales were pulled forward into the 12/19 quarter at the expense of the next.

- Amortization of intangible assets in the 12/19 declined by $33 million (about 9 cps) compared to the comparable year-ago period. However, gross amortizable intangible assets have remained steady for the last eight quarters. In addition, the bulk of intangible assets resulted from the 12/17 quarter acquisition of CR Bard and almost all are being amortized over 13-14 years which further indicates that the drop in amortization is not due to intangibles becoming fully amortized. We have noted in the past that the company adds back amortization of intangibles to its non-GAAP earnings figures which totally ignores the cost of the Bard deal. However, this means that non-GAAP figures did not benefit from the lower intangible amortization, unlike reported GAAP numbers.

- Lower share-based compensation added about 3 cps to earnings growth in the quarter.

- Inventory DSI rose by almost 7 days over the year-ago quarter. There was no discussion of the cause of the spike, but medical product companies" DSIs can be volatile and we suspect this could be due to supporting product launches. Therefore, we do not attach a high degree of concern to it at this point.

Spike in Factored Receivables Hides DSO Increase

On the surface, BDX's accounts receivable DSOs fell by almost 4 days compared to the year-ago quarter as shown in the table below:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Sales	$4,225	$4,585	$4,350	$4,195
Trade Receivables	$2,074	$2,345	$2,220	$2,279
Trade Receivables Days of Sales	45.2	47.1	46.4	48.9

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Sales	$4,160	$4,403	$4,278	$4,222
Trade Receivables	$2,216	$2,319	$2,243	$2,293
Trade Receivables Days of Sales	49.0	48.5	47.7	48.9

However, BDX has disclosed in the past that from time to time, it will factor receivables to third parties to manage its working capital. These amounts are treated as sales and removed from the accounts receivable account. For the last several quarters, there has been no mention of these sold receivable balances as the amounts were not material to the company's results. However, this changed in the 12/19 quarter. Consider the following disclosure from the 12/19 10-Q:

> *"Over the normal course of its business activities, the Company transfers certain trade receivable assets to third parties under factoring agreements. Per the terms of these agreements, the Company surrenders control over its trade receivables upon transfer. Accordingly, the Company accounts for the transfers as sales of trade receivables by recognizing an increase to Cash and equivalents and a decrease to Trade receivables, net when proceeds from the transactions are received.* ***The Company's balance of Trade receivables, net at December 31, 2019 excludes trade receivables of $328 million that have been transferred to third parties under factoring arrangements.*** *The costs incurred by the Company in connection with factoring activities were not material to its consolidated financial results. The Company's transfers of trade receivables during the three months ended December 31, 2018 were not material to its consolidated financial results."*

According to the disclosure, the 12/19 trade receivables balance should be adjusted upwards by $328 million to get an idea of the total receivables balances generated during the quarter. When we do this, we get an adjusted DSO figure of 52.3 which is a 3.3-day increase over the year-ago quarter. This is the first such jump in receivables in several quarters and could be an indication that sales were pulled into the quarter at the expense of the next.

Drop in Amortization of Intangibles

BDX's amortization of acquired intangibles fell by $33 million YOY in the 12/19 quarter despite gross intangible assets remaining relatively constant. The following table shows the breakout of gross intangible assets and the quarterly amortization of intangible assets for the last eight quarters:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Developed Technology	$14,010	$13,960	$13,972	$13,976
Customer Relationships	$4,610	$4,608	$4,610	$4,586
Product Rights	$115	$110	$115	$118
Trademarks	$407	$407	$407	$407
Patents and Other	$488	$445	$433	$407
Amortized Intangible Assets	$19,630	$19,530	$19,537	$19,495
Amortization of Intangibles	$345	$365	$378	$376

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Developed Technology	$13,958	$13,966	$13,937	$13,948
Customer Relationships	$4,585	$4,584	$4,585	$4,566
Product Rights	$119	$121	$121	$131
Trademarks	$407	$407	$407	$408
Patents and Other	$404	$397	$388	$382
Amortized Intangible Assets	$19,474	$19,475	$19,438	$19,435
Amortization of Intangibles	$378	$376	$375	$370

The bulk of these intangible assets resulted from the acquisition of CR Bard in the 12/17 quarter. Disclosures indicated that developed technologies were being amortized over an average of 14 years while customer relationship assets are being amortized over 13 years. Based on the gross balances and the amortization periods of the largest categories, it does not appear that the sudden drop in amortization expense that occurred in the 9/19 quarter and more pronounced drop in the 12/19 quarter were related to an intangible asset becoming fully amortized. **We estimate that the substantial YOY drop in the 12/19 quarter would have added over 9 cps to growth in GAAP EPS in the period.**

As we have noted in past reviews, the company adds back the amortization of intangible assets to its non-GAAP EPS figures under the "purchase accounting adjustments" line item. We disagree with the logic behind doing this as it totally ignores the cost of the Bard acquisition. To put this in perspective, non-GAAP EPS of $2.65 in the 12/19 quarter included $1.27 of purchase accounting adjustments added back to it. Still, the unusual decline in amortization expense would not have had an impact on growth in non-GAAP EPS.

Lower Share-Based Compensation

The following table shows share-based compensation disclosed on the cash flow statement for the last 8 quarters:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Share-based compensation	$82.0	$53.0	$56.0	$59.0

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Share-based compensation	$93.0	$61.0	$54.0	$66.0

The YOY decline in share-based compensation in the 12/19 quarter added about 3 cps to EPS in the period. We view this as a non-operational benefit

Clorox (CLX) 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)

- We have noted with multiple companies with a material presence in Latin America that non-GAAP organic sales growth figures are artificially benefitting from inflation-driven price increases while the related negative impact of FX devaluation is adjusted out of the non-GAAP growth figure. This phenomenon appears to have been a material benefit to CLX's 12/19 organic sales figure. Total organic revenue growth (ex. acquisitions/divestitures and FX) was flat with 6% organic growth reported in the international segment. However, that 6% organic growth was the product of only 1% volume growth and 7% pricing growth with the 8% negative currency impact being adjusted out. (Note that these amounts do not tie due to rounding). The 7% pricing boost was almost certainly driven by the inflationary environment in Latin America, namely Argentina. If we assign a more realistic 1% organic growth to the international segment, we get a total company organic sales growth *decline* of about 1.2% rather than the headline flat organic growth. International sales account for only 12% of total sales, yet the FX adjustment from that segment materially distorted the organic growth calculation.

- Inventory DSI fell by 5 days compared to the 12/18 quarter. We have observed in previous reviews that inventories have been rising which management blamed on the Nutranext acquisition. Our concern level was reduced by management's acknowledgment of the issue and its plans to bring inventory down in the second half of 2019. In the conference call, management

specifically addressed getting better at managing Nutranext inventories to meet demand, moving its supply chain for Brita water filters to the Dominican Republic from China which allows them to carry less inventory, and improvements in its Glad business. Overall, we view the decline in DSI as a positive. However, CLX utilizes the LIFO method of inventory accounting for over 30% of its inventories. Any time a company utilizing the LIFO method works down inventories, there is a possibility that gross margin artificially benefited from the company working its way into the older, lower-priced inventory balances to match against current sales. The LIFO reserve increased as a percentage of total inventory which does not indicate that there was a dramatic expensing of LIFO balances. Likewise, CLX carries less than 2 months of inventory on its balance sheet which would minimize the impact of a material boost from "LIFO liquidation."

- Other (income)/expense was a positive $5 million in the 12/19 quarter compared to a $7 million expense in the year-ago quarter. This was largely due to the revaluation of trust assets related to its deferred compensation plans. This beneficial swing added about 7 cps to reported growth in the quarter but this accounted for only about half of the reported EPS upside.

- Lower pension cost added about 1.2 cps to EPS in the quarter.

Explanation of EQ Rating Scale

Rating	Description
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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