BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

February 21, 2020 | www.btnresearch.com

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IHS Markit Ltd (INFO) EQ Review

Current EQ Rating*	Previous EQ Rating
4+	na

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 initiate earnings quality coverage of INFO with a 4+ (Acceptable) rating.

INFO provides software and information analytics for large companies and governments as well as creating benchmark indices. 85% of revenue is recurring. The company has about 6% organic growth with another 5% from acquisitions.

Leveraging fixed costs allows margins to expand as well, and margins are rising 100-200bp annually to further bolster the growth rate.

The operating model is self-funding. Unless an acquisition is unusually large, it is also self-funding for current operations and acquisitions. INFO is initiating a dividend in 2020 of $0.17 per quarter and the cash flow easily supports that too. We take that as a positive sign as well.

Our primary concerns focus on the acquisition accounting. It uses longer amortization lives on some assets which boosts earnings. Also, adjusted figures for EPS and EBITDA are adding back the acquisition costs along with stock compensation which we believe is inflating results as many of those items require cash outlays and are recurring. Reported EPS for 2019 was $1.23 vs. adjusted EPS of $2.63. We will focus on the adjusted EPS of $2.63 for much of this report when we discuss EPS impacts:

- **The business is self-funding and does not rely on stock compensation to make it free cash flow positive. Nor, does it require working capital to produce cash flow.** It even covers the cost of acquisitions out of free cash flow in most years We consider that a positive for a company that often makes deals.

- **INFO is starting to pay a dividend and return more capital to shareholders. Its current cash flow situation can easily cover the dividend and still allow for share repurchases or acquisitions.**

- **The only working capital situation that may be a negative is deferred revenue DSOs are declining as receivable DSO are rising. The spread between the two has shrunk from a $100 million source of cash to one that turned negative in the 4Q19.**

- **Tax volatility may be ending after the US tax code changes and adjustments last year.** Reported tax rates for INFO were understated in 2018 and overstated in 2019. This also exacerbated the spread between GAAP EPS and adjusted EPS by $0.37 last year.

- **Taxes pose a minor risk still due to jurisdiction.** INFO reports as a UK company with a large US presence. It seems to pass the basic tests for this and Ernst & Young agrees. We believe with the US rate now at 21% and UK

at 19%, this poses a smaller potential problem. The company was only formed for 17 months before the US tax code changed. **We estimate the total risk here to be under $0.15 in EPS and consider the risk minimal.**

- **Acquisitions are still viewed as eternal lived assets compared to those built in-house. The bulk of assets at INFO are acquired intangibles. Goodwill is not expensed at all, while other intangibles are being amortized over 11-12 years vs. immediately or over 3-7 years for internally built assets.** Doubling the amortization would cut GAAP EPS by $0.92.

- **ROI is rising here but is not that high. Because INFO has profits it has a large equity balance and some debt. Using reported operating income, which may be too low and the company's adjusted EBITDA, which we consider too high – the range of ROI is 7.3%-13.2%.** That's not a very high return to earn against valuing intangible tech assets as though they will last forever.

- **Adjusted results are adding back stock option expense. This is an on-going item and the company is spending real cash to buy back shares to limit dilution. In 2019, Adjusted EPS of $2.63 was boosted by $0.44 from adding back stock option expense.** INFO also boosted Adjusted EBITDA by 14% doing this.

- **Adjusted Results are adding back every bit of acquisition cost. That means the on-going amortization of intangibles, the transaction costs, incentive pay, and integration costs.** They are spending cash on acquisitions and integration. It is part of the on-going operating model. We find it aggressive to view a 5% organic growth company as a 10% grower with acquisitions but remove every trace of cost for the acquisitions. **Adjusted EPS is gaining $0.92 from adding back amortization and we estimate another $0.17 from adding back ongoing costs.**

- Capitalized Software is the largest part of PP&E. INFO uses a 3-7 year life to expense that asset which is longer than other companies we have reviewed. **The company is not underinvesting in new PP&E – but it may be understating the expense. We estimate Adjusted EPS is being helped by 5-9 cents here. It may also have added 2-cents last year from cutting A/R reserves.**

Basic Cash Flow Set Up Works

Many times, when we see tech-related companies, especially those making acquisitions to further growth, the cash flow does not fully support the basic operating model. In the case of INFO, internally generated cash covers capital spending, most acquisitions and its new dividend of $0.17/quarter which will be $267 million per year:

	2019	2018	2017
Cash from Ops	$1,251.3	$1,289.5	$961.5
Cap-Ex	$278.1	$222.7	$260.2
Free Cash Flow	$973.2	$1,066.8	$701.3
Acquisitions	$136.5	$1,876.2	$401.1
Adj. Free Cash Flow	$836.7	-$809.4	$300.2

The more sizeable Ipreo deal in 2018 was larger than others and the company is likely to complete more acquisitions in the future. Also, INFO is not dependent on stock compensation or rising deferred revenue to make the cash flow work like many other tech companies. Looking at the components of cash from operations, INFO's are solid too:

	2019	2018	2017
Net Income +/- Gains/Losses	$384.1	$539.2	$417.0
Deprec/Amort.	$573.1	$541.2	$492.5
Change in Def. Tax	-$49.6	-$211.7	-$100.1
Basic Cash from Ops	$907.6	$868.7	$809.4
Stock Comp.	$223.8	$241.7	$261.9
Chg. In Assets/Liab.	$118.7	$188.1	-$116.2
Reported CFO	$1,251.3	$1,289.5	$961.5

Stock compensation and working capital are providing some cash flow to be sure. But even stripping those out, INFO has about $900 million in cash flow with under $300 million in capital spending and just under $270 million in a new dividend. It still has over $300 million per year to make acquisitions too.

The company's goal is to return between 50%-75% of annual capital to shareholders via dividends and stock repurchases and the rest on acquisitions. With total free cash flow in the range of $1 billion (adding in the cash flow from stock compensation and

working capital less capital spending), paying $270 million in dividends and $830 million split between acquisitions and repurchases looks doable. **There is one minor concern here – debt is currently 2.8x adjusted EBITDA. INFO will borrow money to make a larger acquisition, but it wants to stay at the higher end of a range of 2.0-3.0x on its debt. It's already there.** Thus, we believe share repurchases could be lumpy as that is where the final amount of free cash flow appears will be allocated. Cash flow may also be directed toward debt retirement should the company make a large acquisition that requires more borrowing upfront.

We are going to give INFO high marks for this basic model that is self-funding. Many companies are addicted to accelerating growth to keep the cash flow coming in via increasing stock compensation and rising liabilities. INFO is actually seeing stock compensation fall as a component of cash flow.

Also, the tax situation has been the largest moving part for income of late. In 2017 and 2018, income taxes were a benefit to earnings with tax reform and in 2019, the company had a $150 million retroactive expense. That is why the net income and deferred tax situation moved so much. There are some other tax issues that pose risks we will discuss below.

INFO is planning to annuitize its pension plans. The shortfall was only $25 million between assets and obligations. We do not see this plan creating a cash flow issue in 2020. Finally, its purchase of aM in 2017 allowed the owners to retain a minority equity stake. INFO expects to cash them out completely by 2022 at a cost of $70-$75 million.

Working Capital Does Not Have Many Material Components - Falling Deferred Revenues a Minor Concern

There is no inventory at INFO and items like deferred subscription costs are amortized over the subscription period which is normally one-year or less. Those are under 2% of sales. Other current assets include deferred commissions amortized over the life of the contract and derivatives largely for FX hedging. Those are under 2.5% of sales. Those are minor and are conservatively addressed in our view.

That really only leaves Accounts Receivable and Deferred Revenues as the primary components of working capital. In general, these accounts peak in 1Q with Deferred Revenues declining through the year while Receivables start to rise again in 4Q. So, the cash flow is actually front-loaded to start the year, which should also help INFO forecast its cash needs.

2019	4Q	3Q	2Q	1Q
Sales	$1,120.4	$1,112.3	$1,135.5	$1,046.4
A/R	$890.7	$862.7	$854.0	$980.4
Def. Rev.	$879.7	$896.5	$938.7	$1,026.3
A/R DSOs	72.5	70.8	68.6	85.5
Def. Rev. DSOs	71.7	73.6	75.4	89.5

2018	4Q	3Q	2Q	1Q
Sales	$1,067.8	$1,001.0	$1,008.3	$932.1
A/R	$792.9	$760.6	$704.2	$802.7
Def. Rev.	$886.8	$897.0	$872.0	$919.3
A/R DSOs	67.8	69.3	63.7	78.6
Def. Rev. DSOs	75.8	81.8	78.9	90.0

2017	4Q	3Q	2Q	1Q
Sales	$944.7	$904.7	$906.1	$844.2
A/R	$693.5	$655.5	$669.7	$668.8
Def. Rev.	$790.8	$814.1	$869.4	$906.9
A/R DSOs	67.0	66.1	67.4	72.3
Def. Rev. DSOs	76.4	82.1	87.6	98.0

The one concern we have is Receivables DSOs have generally been increasing slightly while Deferred Revenue DSOs are declining. In fact, receivables exceeded deferred revenues in 4Q19. This source of cash flow may be gone. When revenues were $900-$950 million and Deferred revenues exceeded receivables by 10-12 days – it produced $100-$120 million in cash for INFO. At -1 to 3 days now it's consuming $10 million or only producing $30 million.

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Tax Volatility May Be Over

The tax rate has been volatile at INFO for the last few years. This has been tied to the both the US tax rate change in 2017 impacting deferred taxes and then final provisions in 2019 being applied retroactively to 2018:

Taxes	2019	2018	2017
UK Statutory Rate	$141.1	$80.6	$71.9
Foreign tax Diff	-$53.8	-$38.9	-$45.5
Stk Comp Shield	-$43.7	-$39.2	-$61.2
Tax Law Chg.	$179.6	-$178.3	$1.2
* Total Taxes	$242.6	-$115.4	-$49.9
Effective Rate	32.7%	-27.2%	-13.4%

• Total Taxes include some additional valuation allowances and costs not listed here.

For what happened, in 2018 and 2019 – INFO gave the following explanation:

> *"Our effective tax rate for continuing operations for the year ended November 30, 2019 was 32.7 percent, compared to negative 27.2 percent in 2018 and negative 13.4 percent in 2017. The increase in our tax rate for 2019, compared to 2018, is primarily due to net tax expense associated with U.S. Treasury regulations retroactive to 2018 of approximately $150 million. The reduction in our tax rate for 2018, compared to 2017, is primarily due to net tax benefits associated with U.S. tax reform of $141 million."*

Making these adjustments of lowering 2019 by $150 million and raising 2018 by $141 million, makes the effective tax rate in 2019 into 12.4%. That is much more in-line for guidance in 2020 of 14%-16% for the GAAP tax rate. GAAP EPS in 2019 would have been $0.37 higher without this tax transition. The GAAP and Adjusted tax rate are more in line for 2020 with the adjusted rate only 400bp apart at 18%-20%.

Also, it is worth pointing out that INFO has potential tax risks by being based in Bermuda, operating in the UK, and having a large operation in the US including listing on the NYSE – but it splits its tax exposure. There are two potential risks: 1) does the US argue that this is a US company and should be fully taxed in the US? 2) does INFO get investigated on transaction splitting where it may record higher costs and lower income in the higher tax areas.

The company addresses these risks in a couple of areas:

- If the US shareholders after the merger into a foreign company still control 80% or more of the shares – the US could treat it as a US company for taxation under section 7874. INFO believes that US shareholders prior to the merger own less than 60% of the total company.

- Also, intercompany transactions and income that is broken down by geography can be audited and subject to more review by the government.

- Ernst & Young also addressed the complexity of the tax structure and the number of assumptions used to determine the tax bill.

In general, we believe the size of this risk is diminished because the UK's tax rate is 19% and the US is now 21%. If any transaction needs to be adjusted regarding 2019 or 2018, it's only a 2% difference in tax rates. As a combined company, INFO was formed in July 2016. So, when the tax differential 19% vs. 35%, the potential problem should have a review of only about 18 months.

If we look at the taxable income figure for 2017 and adjust for the full tax differential – the maximum exposure may be under $60 million or about $0.15 per share. We are going to rate this as a very modest risk that would likely have a minor impact.

Acquisitions Are Being Given Eternal Life and that Helps Results, but ROI Still Isn't Too High

We see several positives for INFO's acquisition program. It has organic growth and some margin expansion without it:

	2019	2018
Organic Growth	6%	6%
Total Growth	10%	11%
Operating Cost %	65%	67%

It can pay for it with its own operating cash flow as shown above in the cash flow section. It also makes money and reasonable ROI calculations can be made because

there is the balance sheet that doesn't have a multi-billion negative equity balance. Here is a range for ROI using operating income before one-time items and the company's adjusted EBITDA – which we think is inflated and will explore more below:

	2019	2018
Net Debt	$5,014	$5,559
Equity	$8,416	$8,020
Total Capital	$13,430	$13,579
Op. Income	$987	$780
ROI Op Inc.	7.3%	5.7%
Adj. EBITDA	$1,779	$1,565
ROI Adj. EBITDA	13.2%	11.5%

Where we have some issues is the size of the intangible assets and the amortization lives. Noncurrent assets are nearly $15 billion and PP&E is only $658 million of that. Intangibles are $14 billion. Clearly, the bulk of costs at INFO are wages, which are being expensed as incurred. Only some sales commissions are being amortized over the life of the contract and that was GAAP changing the policy – INFO used to expense that as incurred.

However, look at the time frame these assets are amortized vs. the rest of the assets:

Acquired Assets	Lives	Built Assets	Lives
Goodwill	infinite	Buildings	7-30 years
Info Database	5-15 years	Cap. Software	3-7 years
Customer Lists	5-25 years	Computers/EQ	3-10 years
Dev. Software	9-10 years		
Dev. Tech	5-15 years		
Trademarks	3-15 years		

Software built by INFO is getting amortized over 3-7 years, but purchased software has a 9-10 year life? Goodwill has no amortization and the other assets all last longer than assets built in house or worked on by internal employees?

Also, INFO is allocating the bulk of these acquired assets to goodwill and they are not amortizing them at all. How many assets, products, or ideas does INFO work with that last forever?

Acquisitions	2019	2018	2017
Purchase Price	$143.5	$1,877.1	$444.1
Goodwill	$96.0	$1,184.9	$363.0
Intangibles	$61.5	$745.3	$113.8
Goodwill %	66.9%	63.1%	81.7%
Intangibles %	42.9%	39.7%	25.6%

The amortization expense only applies to the intangibles at just over $4 billion while the nearly $10 billion in goodwill is not being expensed at all. By our estimates, these intangibles are being amortized over 11-12 years. You can ignore goodwill and just double the rest of amortization and that would still be an aggressive treatment. That would cut operating income by a fair amount as well as ROI:

	2019	2018
Net Debt	$5,014	$5,559
Equity	$8,416	$8,020
Total Capital	$13,430	$13,579
Op. Income	$987	$780
Extra Amortization	$377	$366
Lower Op. Inc.	$610	$414
Lower Op. Inc. ROI	4.5%	3.0%

Goodwill and other intangibles are being tested against cash flow generation and hurdle rates. They also are viewed against the stock price for impairment. Where this stands right now, the normally defined ROI is low in our opinion but increasing. Even under INFO's adjusted EBITDA measure – ROI isn't that strong, but a 13% figure is unlikely to trigger an impairment. The stock price is double than when many of these intangibles were created and that lowers the risk of an impairment. Overall, we think investors should be aware that a large part of EPS is the result of aggressive amortization schedules. Reported EPS of $1.23 is based on net income of $503 million. If amortization of only $4 billion of the $14 billion in intangibles was 6 years instead of 12, EPS would fall to $0.31 on income of $126 million. That should illustrate how much earnings depend on assumptions for such large assets.

Adjusted Results Are Ignoring the Ongoing Costs of Stock Compensation and Cost of Acquisitions

We understand that there are actual one-time items like a gain or loss or a one-time insurance settlement. However, we do not consider expenses that occur every year as part of the operating model to be something to ignore. Stock options fit that bill at INFO in our view.

	2019	2018
Stock Comp	$223.8	$241.7
Tax Shield	-$43.7	-$39.2
Net Stock Comp/Shr	$0.44	$0.50
GAAP EPS	$1.23	$1.33
Adj. EPS	$2.63	$2.29

In the last two years, INFO has paid over $200 million in stock compensation which comes with a tax shield as well. Because it does not directly consume cash, it is added back on the cash flow statement. INFO along with many other companies is adding it back to earnings. The first problem if it's not a real expense – try not paying it to employees. That somehow never works. The second problem is there is good evidence on the cash flow statement that the stock options consume cash. In 2018, INFO spent $672 million and in 2019 $500 million to repurchase stock to limit dilution of shares. Even with that, the share count rose from 2018 to 2019.

In our view, this should not be added back to either EPS where it inflated adjusted EPS by $0.44 last year or to adjusted EBITDA where it rose by $233.8 million or 14%.

Both figures also add back every bit of the cost related to the acquisitions as well. The goodwill is already not being expensed and the intangibles are being expensed over a much longer time than other asset lives at the company would justify. That is getting to GAAP EPS. Then INFO adds back the amortization of the intangibles, restructuring charges, acquisition-related costs, acquisition-related performance compensation and financing fees. These are not one-time costs. The company very clearly lays out its view that acquisitions are part of its operating model and they also influence the degree to which cash is returned to shareholders. We still give the

company credit for being able to fund the acquisitions with internal cash flow – but it is tough to say that a big upfront cash outlay isn't a cash expense.

We know the amortization of the intangibles is $377 million or $0.92 in EPS. We will estimate that the rest of the acquisition-related charges at a 20% tax shield so $87.6 million becomes $70.1 million or $0.17 in EPS for 2019.

On adjusted EPS of $2.63 – we estimate that adding back stock compensation, amortization of intangibles, and acquisition-related charges contributed $1.53 to that total. That does not even factor in that the amortization period seems too long as described above.

On adjusted EBITDA and normal EBITDA – the $377 million in amortization would be added back for both. But, of the adjusted EBITDA of $1,779 million it also added back $311 million of stock compensation and acquisition charges. It would come in at $1,468 million and the company's ROI under that level would be 10.9% instead of 13.2%. Moreover, Debt/EBITDA would already exceed the company's target range at 3.4x.

What this comes down to is without acquisitions, INFO has 5-6% growth. However, it is being viewed as a 10-11% growth story with them. But, it's tough to make the case that the 10-11% growth should be viewed without any of the additional costs.

Depreciation and Reserves Giving Some Minor Increases to EPS

The bulk of the fixed assets at INFO are capitalized software. They are expensing them over 3-7 years. That is longer than many other firms we see. Anecdotally from our reviews, most companies are closer to 3 years with some being 2-3 and others at 3-5 years.

PP&E	2019	2018	Lives
Buildings	$181.1	$208.0	7-30 years
Cap. Software	$1,019.5	$822.2	3-7 years
Computers/Equip.	$378.4	$334.0	3-10 years
Gross PP&E	$1,579.0	$1,364.2	
Net PP&E	$658.2	$579.6	

It looks clear to us that the bulk of the capital spending is going to software. Plus, the computers life span at 3-10 years is likely impacted by other equipment that lasts beyond 8 years. Total depreciation in 2019 was $196 million. If we look at net PP&E from 2018 and divide that by 3 ($580/3 = $193) and the $278 million in capital spending only had a half year's depreciation and we divide by 6 ($278/6 = $46). Depreciation should be closer to $239 million. Instead at $196 million, it looks to be above 4-years.

This may be overly picky because INFO is clearly reinvesting in the business. It is not using older equipment as capital spending is considerably higher than depreciation:

	2019	2018	2017
Deprecation	$196.1	$175.1	$157.0
Capital Spend	$278.1	$222.7	$260.2

However, if it is using slower depreciation, it is adding to EPS and adjusted EPS because INFO does not add back depreciation in the adjusted figure. Using an effective adjusted tax rate of 18%, there may be as much as 5-9 cents of EPS coming in this area.

We also noticed that the company cut its reserve for receivables to $25.6 million from $30.4 despite an increase in the total receivables last year. In 2019, the company wrote off more reserves than normal. If they had kept the reserve level at the same percentage, bad debt expense would have been $8.2 million higher. This added 2-cents to both EPS and adjusted EPS.

Conagra Brands (CAG) Update
Cuts Guidance Again – Strike Three?
Maintain SELL

CAG cut guidance again during the holiday this week blaming poor sales in December and January as an industry problem. We are maintaining our SELL recommendation. The WSJ had an article on Wednesday about how the grocery stores have more control over products these days than the food companies and are emphasizing more store-brand products. It also noted that Clorox lost selling space for Glad products when it boosted prices. We see situations like that as key problems for CAG's Value over Volume plans of raising prices. The company already reported the bottom fell out of multiple products in prior quarters when it raised prices and store-brands did not. At a conference on Tuesday, CAG never mentioned its Value over Volume plan.

We think investors should be alarmed about the following issues:

- **This is not the first time CAG has cut guidance.** After the Pinnacle Foods deal, revenue forecasts were cut in 3Q19 and missed for FY19. FY20 forecasts for revenue were cut after FY19 and FY20 EPS was cut after 2Q. Now it has cut revenues and EPS again. FY20 forecasts call for lower EPS two years after the merger as the best case.

- **After Pinnacle Foods became a rescue plan for the products and revenues instead of merely integrating two companies and cutting overhead – CAG touted its prowess in remaking brands with new products. Pinnacle's portfolio was going to roll-out many new products in 2H20 and return sales to high levels. They just cut 2H20 sales forecasts.**

- **CAG also cut margin forecasts.** We cannot recall a quarter when management didn't tout that they are exceeding synergy goals and achieving them earlier than planned. Also, they are divesting lower margin weak brands. We have noted that CAG's history of growing margins is much less about brand building and more about divesting lower-margin items.

- We noted that inventories looked at least 10-days too high coming out of 2Q20. We believed that would pressure pricing, lead to more incentives, and write-offs. CAG noted that it is reducing guidance because it will write-off more inventory in 2H20.

- The company had easy comps in the 1H20 and sales were still very weak with a 1% volume gain in 2Q20. Now comps get tougher and CAG is posting lower to negative sales overall and in key products.

- We have pointed out in the past that rolling out new products juices reported sales growth because CAG is essentially stocking the channel and doesn't need retail sale-through to equal to the inventory filling the store shelves. There is a one-time bump from that, but it has downsides on existing merchandise. CAG is owning up to those downsides at the Tuesday conference.

Guidance History Shows Lots of Cuts

CAG came out of fiscal 2018 with EPS of $2.11 after posting organic sales growth of -0.2%.

- Fiscal 2019 guidance was for 1-2% organic sales growth

- Fiscal 2020 was expected to see EPS accretion of low-single digits from 2018

- 2Q19, guidance for 1-2% organic sales growth added total EPS forecast of $2.03-$2.08 with PF diluting results

- 3Q19, guidance for organic sales growth was cut to 1%

CAG finished fiscal 2019 with EPS of $2.01 - a miss, and organic sales growth of 0.3% - a miss. Legacy CAG had sales growth of -1.6% and posted $2.15 in EPS. PF came in at -$0.14

- **Fiscal 2020 guidance was for 1.0-1.5% organic sales growth - a cut** and EPS of $2.08-$2.18. The low end would be negative vs. the accretive forecast after the PF deal.

- **2Q20 guidance is cut for EPS** range of $2.07-$2.17.

- **Within 3Q20, guidance is cut to 0%-0.5% organic sales growth and EPS of $2.00-$2.07 – all below original guidance.**

- **Operating margin guidance falls from 16.2%-16.8% to 15.8%-16.2%**

Organic growth and Margins have not been very strong at CAG to begin with:

	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Volume	1.0%	-2.5%	-1.2%	1.2%	-2.2%	0.0%	-0.1%	-2.8%
Price	1.8%	2.5%	0.7%	2.1%	1.1%	2.1%	2.1%	0.6%
Retail Inv.	-1.2%	-1.7%	-0.2%	-1.4%	-0.5%	-0.9%	n/a	n/a
Organic Growth	1.6%	-1.7%	0.5%	1.9%	-1.6%	1.2%	2.0%	-2.2%
Adj. Op Margin	17.1%	15.7%	13.2%	16.3%	17.5%	14.6%	13.9%	15.0%

One of the reasons we were expecting a disappointment in 3Q20 was CAG only posts growth after an abysmal quarter. In 2Q20, it had an awful 1Q20 and 2Q19 to match against. And yet, margins declined.

The Second Half of 2020 Was When Pinnacle Foods Was Supposed to Shine

The biggest miss and admission that Pinnacle Foods was overpriced at more than 15x EBITDA was only months after the acquisition – CAG announced that Pinnacle sales were falling rapidly. It also noted that it would need to remake much of the product lines and rebuild the brands. This surprised CAG too. It expected to see cost synergies only, but to soften the blow of falling margins and revenues – it announced with 2Q19 results that it could find revenue synergies.

"The synergies we say in the upside, these are the cost synergies right. So, the $215 (million) were cost synergies. <u>We did not build any revenue synergies into our model.</u> Now obviously the business is down relative to what we had modeled, so we have to do all the things we discussed to bring that business back. But when you talk about upside going out long-term, we believe that <u>there could be a side on revenue synergies. That's not in the updated cost synergy number that we will have."</u>

"On sales, we now estimate the Pinnacle portfolio will land calendar year '18 at roughly $3 billion, which is <u>about $160 million or 5% below Pinnacle's target</u>. Approximately $30 million of this miss is driven by our post close decisions to exit some year-end promotions that we saw as extremely low ROI. <u>At adjusted gross margin, we now estimate Pinnacle would have closed out calendar year '18 at approximately 28%, which is roughly 230 basis points below its internal targets."</u>

It was also going to remake the Pinnacle brands and expand them with many new products starting in the 2H20 – which is now. That would continue to follow with even more.

"because of the weakness of the Pinnacle innovation, we have sprung into action to stop further proliferation of similar types of SKUs. But <u>we've also sprung in action in terms of rebuilding a new innovation pipeline with the Pinnacle team and the ConAgra team working arm and arm to do that, but that's going to take some time. It's not going to be all at the exact same window, so it won't all be the beginning of the second half of 2020.</u> Whatever we can get into the marketplace faster, we will get in."

On the call this Tuesday, CAG said it is getting new product rolling out faster than anticipated and it has rebuilt the Pinnacle pipeline. After 2Q19 results, they were touting that they had fixed Birdseye and Duncan Hines:

"As expected, sales and distribution on Birds Eye declined as we removed lower performing SKUs from the market. Now, the brand's distribution trend is starting to bend behind new innovation launches…Throughout the balance of fiscal 2020, we'll build upon our category of leading position in frozen with strong innovation. The innovation we launched in the first half of fiscal 2020 is just starting to pick up momentum and we expected to continue to perform

well on the second half of the year, and we're not going to slow down our Birds Eye."

"We're also making great progress on our work to reframe Duncan Hines as a sweet treat to unlock significant growing demand spaces. Our strategy includes refreshed packaging, fund and novel flavors and new shelf-stable and frozen snacking platforms. And as you can see on slide 25, our earliest work, focused on the core shelf-stable baking mixes, has begun to result in share gains as the holiday baking season kicked off. We're building on this momentum by introducing more innovation in the second half, including on-trend keto-friendly cakes and co-branded Oreo cake cups."

They released monthly sales results for October through January for some key product lines:

- Frozen Single Serve Meals started at 6.6% growth which fell to 2.3% growth
- Frozen Vegetables started at -2.4% growth stayed negative and finished at -2.7%.
- Canned Tomatoes started at -5.6%, turned positive in November and fell to -3.0%

Remember, originally sales growth for 2020 was going to be 1%-2%. That was cut to 1%-1.5%. Now it is supposed to be 0%-0.5% after all the product launches for 2H20.

How Can Margin Guidance Decline?

We have never believed CAG was very good at improving profitability. Instead, it was very good at removing low-margin units from the mix and that boosted margins. We have pointed this out a couple of times in the past. CAG touts that from 2015-2018, it boosted its operating margins by 400bp. However, looking more closely it divested the money-losing Ralcorp and sold its lower margin potato business. Adjusting for those divestitures, legacy CAG only had 40bp of margin gain after years of restructuring.

So far CAG sold Lender Bagel and some other smaller assets. It intends to continue doing this focusing on eliminating brands that are chronic drags on results, lower than average returns, and consistently underperforming. All of that discussion sounds like lower margin businesses to us. Taking that out of the mix should boost margin. Regarding the discussion this week about divestitures lowering targets sales and margin targets – CAG adjusts for acquisitions and divestitures in its organic and adjusted figures. So, this isn't a case of losing total dollars when they look at profits and sales as organic and adjusted figures are what is followed. Pulling a lower margin unit out of both periods should boost adjusted margins over-reported. Pulling it out of only the current quarter should really boost both adjusted and reported margins y/y.

If investors want to talk destruction of capital – we'll point out CAG paid over 15x EBITDA for Pinnacle Foods and the laggard stuff it is selling is probably fetching 5-6x EBITDA. But we only focusing on margin impacts here.

We have also talked about how CAG cut over $100 million from annual advertising to pick up margin. CAG points out that it sees traditional advertising as a low-ROI proposition and is pushing more of it into retail investments that are recorded as a reduction of sales. At 1% of organic sales that is about $28-$30 million per quarter. Also, some of that was already being done in the past so it's not as though the $28-$30 million in retail investments started at zero as CAG cut advertising by $25-$30 million per quarter. In the last two quarters, the retail investment levels are already declining too. They fell from 1.7% in 1Q20 to 1.2% in 2Q20. Against 3Q19, the level was 1.4%, which may set CAG up for an easier comp there – but they reduced the margin forecast.

Synergies are also higher than forecast according to CAG. At first, they were going to find $215 million in cost savings by integrating Pinnacle. As Pinnacle's revenue derailed, CAG said it would find more synergies and raised the target. Now they have increased it to $305 million. Some of this is also coming in faster than anticipated. $23 million in cost savings is worth about 1% in margin per quarter to margins and CAG cut the forecast by 40-60bp for the year.

Pricing is also what is driving sales by 1%-2% per quarter. This is normally a big margin driver. It doesn't cost any more to make, package, and ship a frozen dinner if is priced at $3 or $4. Most of the higher pricing should drop to the operating income line.

What scared us the most about this as a sell recommendation is there are 4-levers working toward higher margins. Even if synergies and pricing come in lighter than forecast, they should still boost margin. Culling lower margin units and cutting advertising almost guarantee higher margins too. With CAG cutting forecasts on margin amid those tailwinds, we see that as a significant red flag.

We See Margin Decay and Weaker Sales from the Inventory Change-Over

The growth story according to CAG is rolling out new products and inventing brands. Giving retailers more support to carry the new products and ensuring they help the retailer drive traffic and sales. That is supposed to enable CAG to boost prices and profitability as its sales grow too.

We have pointed out several problems with this strategy in the past and the first one is what do you do with current inventory on the shelves? The retailer has limited space and people still only eat so much in a given day. Rolling out new products often requires the existing inventory to be marked down and moved.

Coming out of 2Q20, we wrote that CAG's inventory looked about 10-days too high. 2Q20's inventory was 79.9 days. In 2Q19, the inventory figure was skewed by having the Pinnacle deal happen in the quarter. **Compared to 64 and 70 days in the prior years, 2Q20 at basically 80 days looked high and 1Q20's figure also looked very high.**

	1Q20	4Q19	3Q19	2Q19
Inventory	$1,755.7	$1,563.3	$1,638.6	$1,729.7
DSI	92.8	74.9	76.5	92.5

	1Q19	4Q18	3Q18	2Q18
Inventory	$1,108.5	$988.7	$1,016.7	$1,059.2
DSI	76.1	64.9	66.5	63.8

	1Q18	4Q17	3Q17	2Q17
Inventory	$1,068.8	$927.9	$1,046.4	$1,113.7
DSI	75.9	63.5	70.2	70.5

At the conference this week, CAG announced that current inventories have two problems. First, it's older and needs to be cleared. Second, retailers are less keen to order more when CAG is promising them these products will be discontinued. **As a result, CAG is forecasting an increase in inventory write-offs for the 2H20. That should impact pricing and likely will cause more retailer incentives to rise too. Both should reduce growth and lower margins.**

The next problem with clearing the shelves is that discounted inventory does get sold to consumers. Whether its frozen pot-pies, broccoli, or cake mix – consumers take advantage of the bargain and their pantry inventory grows. **Now, when the new product shows up with a new label or larger-size – there is a group of potential consumers who don't need any more as they work off their pantry inventory at home.** Also, CAG is showing up with higher prices for the new products and the consumers have been conditioned to pay discounted prices and it will take them longer to buy again for that reason too. That slows retail sell-through of the new inventory.

The initial stocking of the channel offsets some of those write-offs and discounts. However, retailers also require higher incentives and investments to bring in a new product, especially at a higher price. CAG reports sales net of these incentives so that mitigates sales and margins too. Other products at lower prices whether branded-food competitors or store-brand also are competing with the new products. **Only a year ago, CAG was seeing Marie Calendar sales fall swiftly and steeply because retailers allocated space to lower-cost competitors** as CAG was booking price increases.

The key takeaway is none of this happens in a vacuum. Retailers make higher profits on their own brands most of the time. They simply are not going to give space away to higher-priced goods. We think this causes the new products to produce an initial pop, but it takes longer for sales to build than many think and then they lap the roll-out and sales growth y/y disappears and depends on retail sell-through instead of initial inventory stocking. This is why many of CAG's earnings presentations will call out a couple of products with new rollouts growing at double-digit rates. Yet, total sales are growing at less than 1%. The next quarter another product is touted and the prior one forgotten. **CAG talks about inventing this system since 2015 – when have total sales ever grown very much?**

	2Q20	2019	2018	2017
Organic Growth	0.1%	0.3%	-0.2%	-5.0%

Finally, CAG seldom does well against a tough comp and 3Q20 faces one of the toughest comps of the last two years and a strong sequential comp when sales have already been negative y/y for several key products in the current quarter.

Kraft Heinz (KHC) EQ Update- 12/19 Quarter

Current EQ Rating*	Previous EQ Rating
3+	2-

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 upgrading our earnings quality rating to 3+ (Minor Concern) from 2- (Weak).

- KHC's debt rating was downgraded to junk status last week by Fitch over concerns that the company's decision to keep its dividend at 40 cps per quarter and the expected 8% decline in EBITDA in 2020 would prevent the company from reducing its leverage ratio to under 4 quickly enough.

- Despite the downgrade, we estimate the dividend will still consume only about 76% of free cash flow in 2020 leaving about $500 million left over for debt reduction. Management expects 2020 to be a year to stabilize and serve as a base for future growth. Its basic turnaround plans include reducing the number of SKUs, focusing on higher-growth brands and exiting or divesting slower ones, supply chain cost reduction, and scaling back lower ROI marketing programs and focusing on ones with higher ROIs. Given the established nature of many of its brands (Heinz, Kool-Aid, Jell-O) it does not seem far fetched to expect the company to achieve low single-digit EBITDA growth in 2021 which could see the net leverage ratio below 4x. Well-executed divestitures could further boost debt reduction efforts as well. We also observe that investors are getting an almost 6% dividend yield while they wait.

- KHC wrote down $473 million of goodwill related to the Australia-New Zealand and Latin America reporting units and $273 million of intangible assets related to the *Maxwell House* brand in the fourth quarter. As of 12/19, $13.4 billion of intangibles with fair values less than 10% greater than their

carrying value with another $3.6 billion with fair values between 10-20% greater than carrying value. The company has even warned that intangibles balances with fair values that exceed carrying value by more than 20% could be subject to write-down as much of those values were determined at the time of the 2015 Heinz acquisition and there is a possibility of changes in assumptions that could conceivably lead to a downgrade in the future.

- Furthermore, part of the reason for the fourth quarter write-downs was an increase in the discount rate utilized in the valuation calculation to reflect an increase in risk perceived by investors related to the stock price decline. Could the debt downgrade and associated stock price drop be cause for a higher discount rate? Finally, the company noted that lower market rates keeping a lid on the discount rate increase helped offset some of the negative inputs in the fair value calculation in the fourth quarter. It also warned that future market interest rate increases could increase the likelihood of future write-downs. All of these factors make us believe we have not seen the last of write-downs on par with the fourth quarter and should the company's turnaround plans not materialize, there could very well be more $1 billion-plus charges in the future on par with last year's first quarter.

- The company had previously identified a material weakness in internal control related to its procurement functions. As of the 12/19 10-K, the company had yet to mark these issues as resolved. We are not especially alarmed by this as management is dealing with multiple problems. We also observe that given all the scrutiny surrounding the company's accounting, we expect management is seeking to be as conservative as possible and would be quick to identify any problems it might discover.

- We note that since our original assignment of a 2- (Weak) rating in 2018, the company has unwound its receivables securitization program and has scaled back its payables factoring programs which are both improvements to the quality of reported results.

Cash Flow Should Be More than Sufficient to Cover the Dividend

As noted above, Fitch recently downgraded KHC's debt to junk status (BB+) over concerns that the company's commitment to keep its dividend at its 40 cps quarterly rate will not allow it to deleverage quickly enough. Fitch stated:

> *"The downgrade reflects Fitch's view that Kraft's leverage will remain elevated above 4x for a prolonged period due to ongoing EBITDA challenges and limited near term debt reduction potential. Following Kraft's commentary around 2020 operating headwinds which would suggest a nearly 8% EBITDA decline and its commitment to maintain its dividend as announced Feb. 13, 2020, Fitch estimates the company may need to divest up to 20% of its projected 2020 EBITDA to support debt reduction necessary to reduce leverage to below 4.0x versus 2019 leverage of 4.8x."*

Despite the downgrade, we see KHC's dividend as well-protected. The company posted adjusted EBITDA of $6.1 billion in 2019. During the call, the company cited several specific headwinds that will result in a decline in EBITDA in 2020, which are shown in the following table:

2019 Adjusted EBITDA	$6,064
Company Guidance of YOY EBITDA Impacts	
Divestitures	-$110
Incentive Compensation	-$140
Commodities, Distribution, Supply Chain	-$150
FX	-$60
Estimated 2020 EBITDA	$5,604
less	
Cash Interest	-$1,306
Cash Taxes	-$974
Estimated 2020 Operating Cash Flow	$3,324
Capex	$750
Estimated 2020 FCF	$2,574
Cash Dividend	$1,954

Divestitures made in 2019 will cut $110 million while the return of previously suspended incentive compensation will add $140 million to costs. Higher commodity and supply chain inflation will drain another $150 million which FX is expected to be a $60 million headwind. This implies 2020 EBITDA of $5.6 billion. If we leave cash interest and tax expense flat with 2019 levels and assume a neutral working capital impact, we get an estimated operating cash flow figure of $3.3 billion. Management stated during the call that it does not anticipate a significant cash spend related to restructuring activities, and it expects capex of $750 million in 2020 which will result in $2.5 billion of free cash flow. The dividend at the current 40 cps quarterly rate will consume $1.9 billion in cash. This is consistent with the company's contention on the call that *"…our free cash generation as a percentage of net income should go up, and we continue to expect to generate healthy levels of cash flow, at least $500 million in excess of our normal dividend payout in 2020."*

While a 76% free cash flow dividend payout is not especially conservative, the dividend certainly appears safe and leaves room for debt reduction. Approximately $1 billion in debt comes due in 2020 but this can be more than covered by the company's $2.3 billion in cash and equivalents. KHC's total net debt to adjusted EBITDA is about 4.4x. Assuming the company uses all of the $500 million in excess free cash after dividend to pay off debt and using the $5.6 billion estimate for 2020 EBITDA, the net leverage ratio will rise to about 4.7 by the end of year and will decline about 0.2 per year assuming EBITDA remains flat at the lower 2020 level. However, the company has made it clear that it will be looking for strategic opportunities to divest certain brands which could significantly boost the debt-reduction effort. Given all these factors, the dividend appears to be safe at this point in time.

Management indicated that it looks for 2020 to be a year to stabilize and represent a base from which to grow. While it disappointed investors in the fourth quarter call by delaying details for its turnaround strategy, it has identified 1) SKU reduction with a focus on growing brands and discontinuing less attractive brands, 2) supply chain cost reduction and 3) scaling back marketing programs with low ROI as some of the areas of focus for next year and beyond. It is early in the process but given the popularity of many of the company's brands (*Heinz, Kool-Aid, Jell-O*) our initial thoughts are that it is not far fetched to expect the company to be able to eke out at least low single-digit EBITDA growth in 2021. Two years of $500 million in debt reduction per year and a return of EBITDA to $6 billion could put net debt/EBITDA below 4x by the end of 2021.

Status of Goodwill and Intangibles

We have documented KHC's massive write-offs of goodwill in 2018 and early 2019. These charges continued into the 12/19 quarter as its year-end review showed that it was more likely than not that the carrying value of its Australia and New Zealand, Latin American Exports and Northeast Asia reporting units were above their fair value. This was driven by weaker than expected growth, new management, and the 2020 operating plan which established a revised set of expectations for the coming years due to market factors which will reduce revenue and margins. This led to a $473 million goodwill write-down taken in the fourth quarter for the Australia and New Zealand and Latin America reporting units and a $278 million write-down of the intangible asset associated with the *Maxwell House* brand.

KHC also warned in the 10-K that the upcoming combination of its EMEA, Latin America, and APAC zones into one reporting unit as well as moving the Puerto Rico business from the Latin American zone to the United States zone will trigger an impairment test that will make remaining goodwill associated with these units ($278 million) subject to additional impairments.

Even after all the writedown, goodwill of $36 billion and intangible assets of $49 billion account for about half of total assets and almost all of shareholders' equity. As of the end of the year, $13.4 billion of intangible assets associated with *the Kraft, Planters* and *ABC* brands had fair values that were less than 10% above carrying value while another $3.6 billion associated with the *Oscar Meyer, JetPuffed* and *Quero* brands were had fair values of 10-20% above carrying value. 20% is not a very big cushion as the company warns in the 10-K regarding its reporting unit goodwill:

> *"Our reporting units that were impaired in 2018 and 2019 were written down to their respective fair values resulting in zero excess fair value over carrying amount as of the applicable impairment test dates.* ***Accordingly, these and other individual reporting units that have 20% or less excess fair value over carrying amount as of their latest 2019 impairment testing date have a heightened risk of future impairments if any assumptions, estimates, or market factors change in the future.***
>
> ***Although the remaining reporting units have more than 20% excess fair value over carrying amount as of their latest 2019 impairment testing date, these***

amounts are also associated with the 2013 Heinz acquisition and the 2015 Merger and are recorded on the balance sheet at their estimated acquisition date fair values. Therefore, if any estimates, market factors, or assumptions, including those related to our enterprise strategy or business plans, change in the future, these amounts are also susceptible to impairments."

On the subject of assumptions, it is also worth remembering that one of the reasons for recent cuts to fair value estimates was due to higher discount rate assumptions to reflect perceived higher risk due to the company's stock price decline. (A higher discount rate reduces the present value of expected future cash flows.) This leads us to wonder if the recent stock price decline coupled with the debt downgrade could increase the likelihood of future writedowns. It is also worth remembering that the recent fair value calculations have benefitted from a decline in overall market interest rates reducing the discount rate. This was visible in the company's comment in the 10-K regarding the *Maxwell House* writedown:

> *"The reduction in fair value of the Maxwell House trademark was driven by expectations of near-term net sales and profitability declines outlined in the 2020 annual operating plan in response to consumer shifts from mainstream coffee brands to premium coffee brands.* ***These shifts in expectations were partially offset by declines in market driven discount rates observed in the fourth quarter of 2019. Should market interest rates increase in future periods, the likelihood for further impairment will increase****. We determined the factors contributing to the impairment loss were the result of circumstances that arose during the fourth quarter of 2019. This brand had a carrying value of approximately $823 million after the recorded impairment."*

This highlights another risk of higher market rates for companies with large amounts of goodwill and intangibles with narrow spreads between fair values and carrying values.

In summary, it looks as if KHC remains at risk of seeing write-off activity similar to the fourth quarter for the foreseeable future. However, should the company's turnaround plans not bear fruit and results continue to erode, there is potential that significant amounts of goodwill and intangibles related to key Kraft brands as well as acquired Heinz brands could lead to more billion-dollar surprises.

Status of Material Weakness

KHC's accounting department has been put through the wringer in the last two years. In late 2017, the company was required to restate two 10-Qs due to failing to properly apply ASU 2016-15 for the accounting of cash flow. This led to the identification of a material weakness in internal control over financial reporting. This was followed by the 2/2019 announcement of the $15.6 billion write-down of goodwill and intangibles and an SEC investigation into improper handling and accounting of its procurement procedures. More restatements followed.

The company continued to cite a material weakness in financial control in its 2019 10-K stating:

> *"As previously disclosed in our Annual Report on Form 10-K for the year ended December 29, 2018, we identified a material weakness in the risk assessment component of internal control as we did not appropriately design controls in response to the risk of misstatement due to changes in our business environment. This material weakness in risk assessment gave rise to the specific control deficiency described below, which we also determined to be a material weakness, and both material weaknesses have not been remediated as of December 28, 2019:*
>
> *Supplier Contracts and Related Arrangements: We did not design and maintain effective controls over the accounting for supplier contracts and related arrangements. Specifically, certain employees in our procurement organization engaged in misconduct and circumvented controls that included withholding information or directing others to withhold information related to supplier contracts that affected the accounting for certain supplier rebates, incentives, and pricing arrangements, in an attempt to influence the achievement of internal financial targets that became or were perceived to have become increasingly difficult to attain due to changes in our business environment. Additionally, in certain instances, we did not have a sufficient understanding or maintain sufficient documentation of the transaction to determine the appropriate accounting for certain cost and rebate elements and embedded leases. This material weakness resulted in misstatements that were corrected in the restatement included in our Annual Report on Form 10-K for the year ended December 29, 2018."*

We are not overly alarmed that the material weakness has not been classified as resolved yet. At this point, there is so much attention focused on the company's accounting that we are inclined to think management will be very focused on being "above reproach" and quick to report the discovery of any material misstatements.

Snap-on (SNA) 4Q 19 Update
Maintain SELL

SNA reported earnings in line with expectations in the quarter but missed the consensus top-line target. We note the following items of concern in the quarter:

- We have noted in past reviews that SNA's inventory has been rising for the last several quarters which the company has attributed to new product introductions and higher demand for certain products. The increase in inventory days (DSIs) accelerated in the fourth quarter, rising to over 137 from just over 124 last year. The 13-day increase compares to approximately 10-day and 8-day YOY increases in the 9/19 and 6/19 quarters, respectively. Once again, the company stated that the increase was "*primarily to support the introduction of new products, higher levels of demand across critical industries, including demand for U.S. manufactured hand tools, as well as to improve service levels to our customers."* However, during the call, management also stated about the higher inventory levels: "*I think the biggest increase in inventory actually is new product introduction.* ***And the take-up pace was not as rigorous as we would like for that, and we're confident looking to the future. But as you know, we keep targeting a higher level of sales growth. And when we don't achieve it, the product is there and available but it's in inventory rather than in the sales line."*** After four straight quarters of near 10-day increases in DSIs, we believe the situation has reached the point that investors will be alarmed should the increases not at least moderate significantly going forward.

- With regards to inventory, we would point out that SNA utilized the LIFO method of inventory accounting for 42% of its total inventory as of 12/19, up from 39% a year ago. The company utilizes FIFO inventory for 100% of its international inventory and 32% of its US inventory. If we do start to see inventory balances decline over the next few quarters, the company could enjoy an artificial gross margin tailwind as it begins to match older, lower-cost LIFO layers of inventory against current sales. With almost 5 months of inventory on hand, the impact could be material.

- Short-term contract receivables days of sales were essentially flat year-over-year, but long-term contract receivables rose by almost 3 days. This is consistent with the trend over the last few quarters. Total finance receivables days rose by more than 5 days versus the year-ago quarter. This was an improvement over the mid-teens growth in the previous two quarters. The finance receivables allowance for bad debts fell to 3.65% from 3.71% with lower provision expense adding about 3 cps to earnings. On the surface, the percentage of finance receivables past due was flat, but we note that the percentage of finance receivables over 90 days past due but still accruing jumped to 1.01% from 0.96% last year. This boosted the non-performing finance receivables percentage to 1.73% from 1.69%. While not a huge jump, it is the first YOY increase in some time and this should be monitored in upcoming quarters. Contract receivables fared better with the total past due balance falling to 0.8% versus 1.8%. last year.

- SNA was required to adopt ASU No. 2016-13 under which the company must record an estimate for all credit losses based on "historical experience, current conditions and a reasonable and supportable forecast." This replaced the previous method under which the company only utilized historical loss experience to estimate its credit loss reserves. The company estimated in the 10-K that adoption in 2020 will result in a one-time increase to the allowance for doubtful accounts of $8 million with an offsetting adjustment to beginning retained earnings.

- Lower pension expense again added more than 3 cps to EPS growth in the quarter. The decline has been primarily a result of lower amortization of unrecognized losses along with a higher expected return on plan assets. However, the company stated in the 10-K that it is lowering the discount rate used to calculate pension costs to 3.4% for US plans and 2.1% for international plans from a worldwide rate of 4.2% used in 2019. As such, the company expects pension costs to increase in 2020. To put this in perspective, adjusted EPS rose by just 5 cps in the 12/19 quarter. Removing the pension expense decline in 2020 will take away a key tailwind to recent growth.

- The company disclosed in the 10-K that advertising and promotion expense fell to $47.7 million in 2019 versus $55.6 million and $55.7 million in 2018 and 2017, respectively. Advertising and promotion expense is not disclosed on a quarterly basis, but for the full year, the decline added over 11 cps to earnings.

Explanation of EQ Rating Scale

Rating	Explanation
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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