BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Macy's (M) 4Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on Macy's after its 4Q19 results that were stronger than expected. The bigger story here is the latest efforts to eliminate laggard operations, right-size the store footprint and emphasize the growing areas of the business – Polaris. We wrote in more detail about that plan and areas where we think Macy's can beat forecasts in our view over the next 3-years. We urge readers to read that report from February 7, 2020 again as we update some trends from 4Q results here.

The company expects the most disruption to the business in 1Q20 and it should be a tough period. That is due to consolidating corporate offices, the closing of the first 30 stores, restructuring in logistics, building out new departments in stores that will remain in the fleet, and adding to loyalty programs. However, management believes the results should improve throughout 2020 as more of these tasks are completed.

Guidance for 2020 calls for sales of $23.6-$23.9 billion – down between 3.9%-2.7% with same-store sales comps down 2.5%-1.5%. Margins are expected to be essentially flat with cost savings offsetting areas of margin pressure such as shipping and EPS of $2.20-$2.40 before asset sale gains vs. $2.53 in 2019.

- We believe comp sales will exceed guidance for several reasons. The stores being closed are posting comps 300bp lower than the company overall. The company noted in 4Q that removing the 30 stores that were closed at the end of the quarter boosted same-store comps by 10bp. The 125 store closings are expected over 3-years, but there will likely be a few more in 2020 that further help comp sales by removing them.

- The Growth Model store remodels started with 50 stores in 2018, became 150 in 2019 (51% of sales) and will become 250 in 2020 (78% of sales). The original 50, comped 350bp higher than the total company in 2019. The total 150 Growth Model stores comped 300bp higher than the total company in 4Q19.

- Destination Business - six large categories that are being emphasized as they are 40% of sales were up 2.9% in 2019 and 4.3% in 4Q19. Average Unit Retail here was up 8% for dresses and 11% for fine jewelry.

- BackStage lowers Average Unit Retail – but is still comping mid-single digits. It is seeing gross margin rise and inventory turns increase. Also, BackStage boosts sales of non-closeout items in the store.

- Average Unit Retail is unlikely to face the inventory write-downs Macy's had in 2Q19 and the company has easy comps there for 2020. The company noted that it exited 4Q with inventory down 1.4% and likes where they are in having inventory to match sales. Also, it has Vendor Direct and Hold-and-Flow more established now which reduces inventories and risk of mark-downs.

	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Comps	-0.5%	-3.5%	0.3%	0.7%	2.0%	3.3%
Transactions	-0.5%	-0.4%	5.3%	5.7%	6.2%	3.8%
Items/Trans.	-1.0%	-1.8%	-1.8%	-2.2%	-4.9%	-3.1%
Avg Unit Retail	1.1%	-1.8%	-3.0%	-2.7%	-0.3%	2.6%

We believe transaction figures need to rise, but the company is gaining in both items per transaction and dollars spent per item.

- Total digital sales are growing at high single-digit rates too and are 25% of sales. The lost sales from 30 closed stores is likely no more than $500 million. The company noted that all 125 stores to be closed are less than 10% of total sales or about $2.3 billion. Digital sales are $6 billion and may continue to rise by $400-$500 million and offset the sales from the closed stores in 2020.

- We also doubt that Macy's loses all the sales from the closed stores. Often there are other Macy's locations nearby and shoppers can also migrate to digital options. Macy's is working on those transitions. If digital growth and other stores gain more than the lost sales of the closed stores, and the rest of the store base has a -2% comp – that's less than $500 million of lost sales vs. forecasts of $700 million to $1 billion in lower sales.

- International Tourists were a -10bp drag on comps in 4Q. With the current strong dollar and coronavirus issues – that seems likely to continue.

- Flat margins for 2020 also may conservative. Macy's is coming into 2020 with a decent amount of cost-cutting already in place through cutting staff, closing stores, and consolidating overhead locations. It also began work to optimize the supply chain in September. The heavy mark-downs on inventory in 2Q19 was a 22bp drag on margins in 2019. Lower inventories and new inventory control programs seem to mitigate that. Plus, pricing is increasing.

- Offsets to margins are free shipping and deleveraging fixed costs. The company saw a 50bp headwind from shipping in 2019 and sees 50bp more in 2020 for gross margin. That is basically $120 million. Offsetting that is not repeating 2Q's mark-downs of over $50 million. Also, offsetting that is better AUR – which is rising. Gross margin at BackStage is also increasing. Further offsetting comes from having people ship to the store, which is cheaper and where they tend to spend 25% more. Shipping to the store is rising rapidly. Macy's expects $600 million in gross margin gains from Polaris by 2022 and thinks $100 million can be realized in 2022. That is enough to offset the shipping headwind. Deleveraging fixed costs will be most pronounced in 1Q with the turnover of staff, store closings, and consolidations. That impact will be greater in a seasonally weaker quarter too. However, when sales are stronger in 4Q – those cost savings should be having a larger impact.

Our conclusion here is simple. Normally when retailers close laggard stores, it helps comps as low figures drop out of the equation and some sales at closed locations transfer to remaining stores and boost the comp there. Macy's admitted that closing a small part of those stores late in 4Q, helped comps 10bp already. Half the sales at Macy's are growing at 300bp better than comps for the full company – that would have them at 2% positive comps. One-quarter of the sales is digital growing at 7%-9%. Plus, there are easy comps to match against and pricing is up. To us, that does not add up to a loss of $500 million in closed locations plus -2% comps overall.

We expect 1Q20 to look awful with the first part of this transition. But we believe that Macy's is set up to beat forecasts for much of 2020 as it devotes more attention and investment to the areas of the company that are working well, and those areas are huge parts of the overall business. Also, Macy's is not a basket case retailer that has been reporting never-ending negative growth figures. Other than 3Q19, its comps have generally been positive for a decent time.

Starwood Property Trust – 4Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on STWD. The company's $0.47 in core EPS was a disappointment by 6-cents. The miss comes primarily from the company writing a retail JV investment from $72 million to zero which impacted core EPS by $0.24. Offsetting that was an $83 million gain on its Ireland property. However, there was a $23 million tax adjustment as part of the deal, reducing the gain to core earnings to $60 million or $0.20 per share. There remain several positives going forward:

- **The retail JV may be restructured and bring back some value that was written off in 4Q.** If nothing positive happens, that potential loss is fully recognized. There isn't other retail exposure beyond the soon to open America Dream Mall loan made at a 50% LTV.

- **Commercial and Residential Lending contributed $0.37 of the $0.47 in core EPS for 4Q. Commercial set a record for $2.2 billion in new lending but 60% didn't close until the final two weeks of 4Q.** That sets STWD up for a bigger impact on EPS for 1Q20. The Residential side doubled the loan portfolio y/y and it rose 10% from 3Q. That also should be a tailwind for EPS growth in 1Q and 2020. Residential is producing a double-digit yield.

- **Infrastructure that STWD acquired from GE was only 2-cents of core EPS for 4Q.** The company has been selling GE loans and letting other lower margin loans run-off in order to match durations for assets and funding. **In 4Q, this unit is now growing again and funded $424 million in loans – with 85% coming in the second half of 4Q.** New loans are coming in with IRRs > 13% and funding is in place to add to this unit. That should create another source of rising EPS in 1Q and going forward.

- **We have talked about STWD setting up its portfolio to profit from both rising and falling Libor rates. A 100bp decline adds about 9-cents and a 200bp decline would add 20-cents at this point.** STWD has 190bp floors on all 2019 originations in CRE and all domestic loans have floors with 32% in the money now. That should also help drive EPS in 2020.

- **STWD sees its property sector continuing to perform well. First, it refinanced its funding on the Medical Office property and first Florida multifamily portfolio. This boosted the cash yield for the property unit to 15%.** Also, the Florida assets can see rents rise based on income growth, but not decline. Finally, cap rates are declining with interest rates and as the cost of new construction is rising – meaning less new supply. The company sees the cash returns rising and accumulated property gains becoming a larger hidden asset for the stock.

- **One mixed item that will hit in 2020 is the adoption of ASU 2016-13 – CECL (Current Expected Credit Loss) model. Under this new accounting treatment, FASB requires firms to evaluate the potential loan losses over the life of the loan rather than booking impairments after a credit issue arises.** The idea is to smooth out potential losses over time and to employ some historical evidence to the model. As a result, STWD has subscribed to third-party databases to incorporate historical losses for Commercial Real Estate Loans and Infrastructure loans. The final outcome is expected to be:

    - **STWD's Loan-to-Value on loans is expected to decline below 60%.** It currently uses a more conservative standard in evaluating its loans and the 64% ration should drop noticeably.
    - STWD has not had a history of loan losses and the prior system worked off losses triggered by specific events. **Therefore, the company estimates that it will set up an allowance of $30-$40 million based on third-party historical data of losses.** That will be in addition to $0 currently reserved at the Infrastructure unit and $3.6 million of specific reserves.
    - **This charge will not impact core EPS. It will be charged against equity when it is established. After that, changes in the reserve allowance will flow through GAAP earnings.**

- **Europe may get more attention from STWD going forward.** Barry Sternlicht highlighted that the **banks are not involved; rents are rising in Germany, London, Spain; and the spreads are wider given the low borrowing rates there.** Historically, STWD does not gamble - it matches durations on loans, doesn't want to be caught with FX losses, likes a large cushion on what it views as a worst-case scenario for LTV. So, if STWD starts to make more loans in Europe, we believe it will stick with past form and valuing safety and cash on cash returns along with strong credit analysis. This could become an area where returns may rise going forward also.

- **An interesting comment on the call highlighted that the big tech companies are driving both the stock and real estate markets in several cities. This could be a growing risk factor for real estate** – despite several strong tailwinds (low interest rates, low construction rates, high cost of replacement…) Here is the discussion from Barry Sternlicht:

  "There are markets and cities where you shouldn't invest. We have an interesting portfolio because we don't have a lot of exposure other WeWork in New York City (Lord & Taylor building), for example. And we are not particularly bullish on the New York City office market.

  We think expenses might rise faster than the rents and you need to be super careful there. Cap rates are obviously low, but they may change if people get the view that net rents are going to fall. ***<u>And what's driving all these major markets is the same thing that's driving the stock market, five companies. They are expanding into Berlin, into New York, into Toronto and even Nashville.</u>*** *Amazon or what they call you the fangs and you can add three or four other names, Salesforce, these are driving these commercial property markets.*

  And if they get in trouble in the stock market, they will get in trouble in the real estate market. The markets have never been more intertwined. And it's a very -- ***<u>you don't care about banks expanding anymore. In your cities, you have banks. It's not about banks anymore, it's TMC. And same thing in London, like all the incremental space is being driven by what Google wants, what Amazon wants, what Facebook wants. What Netflix wants or Twitter wants and then a dozen other unicorns. So, for them, the cost of space is minuscule on their P&L military and they don't really care what they are paying, kind of like the hedge fund has evolved. And we would just be careful about the exposure of those markets because actually, the thing that will stop these companies is regulation. It's the hardest thing to underwrite,</u>*** *right. If somebody [thinks] that Amazon is destroying the world and we know it and Congress decides to change things, they will change things. So, it's an interesting world. But there are asset classes, I mean the office markets in United States are fairly sound across the board, other than San*

Francisco or New York. I can't really think of something that I think is in Chicago, there are always more funds. But it's fine, it's stable. But other markets, rents are rising smartly ahead of expenses."

Zimmer Biomet (ZBH) 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 lowering our earnings quality rating to 2- (Weak) from 3- (Minor Concern)

Adjusted EPS of $2.30 beat the consensus by 3 cps. However, we saw multiple red flags that continue to undermine ZBH's earnings quality. We also observe that ZBH's list of non-GAAP adjustments is always long, but its quarters regularly include unusual benefits adding a few pennies to EPS.

- Pension expense fell by almost 3 cps in the 12/19 quarter compared to a year ago. This was almost entirely due to a one-time curtailment gain of $7.2 million. This gain is not removed from the company's non-GAAP disclosures and there was no discussion of it in the press release or the conference call. The MD&A section of the 10-K simply stated that "the decline in other expense, net was driven by higher pension-related gains." As such, we believe this material boost likely "flew under the radar" of many investors. The company's non-GAAP adjustments regularly feature several lines with the 12/19 and 12/18 quarters each including 12 separate adjustments adding back one-time expenses. Some were smaller than the curtailment gain, including the adding back of $5.2 million in quality remediation expenses and $3.9 million in "other charges."

- We remind investors that on the first day of the second quarter of 2019, ZBH bought the rights to certain licensing arrangements from a third party for $192.5 million. The company previously paid royalties for the use of these rights which were recorded under cost of sales. The $192.5 million was capitalized and is being amortized through 2029. However, while results are benefitting from the lower cost of sales, non-GAAP results also have the increased amortization expense added back, so there is no offset. We had previously estimated the benefit to be about 2 cps per quarter based on the amortization period of the capitalized payment. However, the company disclosed in the 10-K that gross margin for the 2019 full year received a 40 basis points boost compared to 2018 as a result of lower royalties. This amounts to about 12 cps for the full year, or about 4 cps per quarter for the three quarters the lower royalty was in effect. The company regularly refers to the benefit of the lower royalty expense, but investors should keep in mind that this material tailwind will expire after the first quarter. For perspective, the approximate 4 cps boost from lower royalty accounted for a third of the 12 cps increase in non-GAAP EPS in the 12/19 quarter.

- Inventory DSIs posted another sizeable jump in the quarter, climbing 21 days to almost 377. As we noted in our review of the 9/19 quarter, management addressed the large inventory balance in the third quarter call, referring to it as a "challenge" and noting that the "*deferred or capitalized costs will flow through at a higher level into 2020, so that's a headwind*."

- The year-over-year pace of receivables factoring fell for the first time in years as ZBH sold a total of $732 million of receivables in the 12/19 quarter versus $764 million in the year-ago period. More importantly, the total balance of US and Japanese receivables sold but still outstanding at the end of the quarter was $270 million compared to $366 million last year. As we have noted before, the sold but outstanding balances do not include sold European receivables for which the company does not maintain servicing responsibilities. Given management's comments, we do not believe these balances are very large. Receivable DSOs adjusted for the sold but outstanding amounts fell by 2 days from last year's fourth quarter.

- We noted in our last review that ZBH warned that the carrying values of its EMEA and Dental reporting units remain susceptible to write-downs. This was quantified in the 10-K as the company stated that: "*In our annual impairment test in the fourth quarter of 2019, we estimated the fair value of our EMEA and Dental reporting units only exceeded their carrying values by less than 5 percent… As of December 31, 2019, the remaining goodwill on the EMEA and Dental reporting units were $749.8 million and $397.7 million, respectively.*

Remember that ZBH reported a $976 million goodwill write-down in 2018 and given the narrow fair value premium for the above segments the chance of another meaningful write-down seems quite possible.

- ZBH announced its latest restructuring plan which is expected to result in total pre-tax charges of $350-$400 million with half expected to fall in 2020. The plan has a goal of reducing annual operating expenses by $200-$300 million by the end of 2023. The company incurred $33 million in charge in the 12/19 quarter related to employee termination benefits, consulting, and project management.

Ball Corp. (BLL) EQ Update 12/19 Qtr.

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 raising our earnings quality rating to 3+ (Minor Concern) from 2- (Weak) with the improvement largely reflecting the deceleration of the pace of receivables factoring.

- BLL's pace of factored receivables is still outrunning sales growth. Receivables sold but outstanding on a days of sales basis rose by 6 days versus the year-ago fourth quarter. However, this compares to a mid-teens YOY growth rate at the end of 2018. Meanwhile, receivables still on the balance sheet declined by almost 5 days on a days of sales basis. The resulting 1-day increase in adjusted receivable DSOs is not overly alarming, although this measure is likely distorted by the October 2019 disposal of the Argentina Aerosol business and the September 2019 sale of the China Beverage Packaging business. In fact, the company stated in the liquidity section of its 10-K that "Excluding the impact of the sale of the U.S. steel food and steel aerosol packaging business in 2018 and the sale of the China beverage packaging and Argentina steel aerosol businesses in 2019, our working capital movements reflect a decrease of days sales outstanding from 42 days in 2018 to 39 days in 2019 and an increase in days payable outstanding from 112 days in 2018 to 121 days in 2019. We will continue to monitor these trends going forward.

- Unbilled receivable days of sales rose by 3 in the 12/19 quarter to almost 19. As we have noted before, this could be influenced by rising aerospace sales, but as with the previous quarter, unbilled receivables on a days of aerospace sales basis rose as well. This continues to erode the quality of reported revenue, in our opinion.

- The loss of a customer in its Saudi Arabia beverage packaging business led to a $64 million write-down of PP&E and goodwill associated with the segment. The company also warned in the 10-K that beginning in 2020, it will change how it reports its AMEA and Asia Pacific beverage packaging segments which had goodwill balances of $102 million and $27 million, respectively. This will result in a new segment to which $62 million of goodwill will be allocated. The disclosure warned that "*Based on the information available at this time, it is reasonably possible that the company will be required to record a non-cash impairment charge for some or all of the goodwill associated with this reporting unit in the first quarter of 2020, as the carrying amount of this reporting unit may exceed its fair value.*"

- Pension costs declined by 5.6 cps in the quarter due to a $22 million settlement gain last year, but this was adjusted out of non-GAAP figures.

Church and Dwight (CHD) EQ Update 12/19 Qtr.

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

- Inventory DSIs rose by more than 3 days over the year-ago quarter which management blamed on the 6/19 quarter acquisition of Flawless. We expressed concern about the increase in inventory seen in the 6/19 quarter because the company did not originally book the Flawless inventory in that period but rather continued to buy inventory from Flawless during the five-month trial period. During the 12/19 quarter, the Flawless inventory hit CHD's balance sheet, so the jump in inventory being driven by the Flawless acquisition seems plausible. We are less concerned about inventory levels at this point but will be looking for the year-over-year increase in DSIs stabilize going forward.

- DSOs based on receivables on the balance sheet were down about a day from last year's fourth quarter. The 10-K indicated that CHD sold $138.9 million of receivables during 2019, up from $112.9 million in 2018. However, as we have criticized in the past, CHD does not disclose the amount of receivables sold but still outstanding at the end of the period, nor does it disclose any quarterly data on the program. This makes it impossible to calculate an adjusted period ending receivables balance to assess the extent to which sales could have been pulled into the end of the quarter through the extension of easier terms. Still, if we just assume that all of the year-over-year increase in receivables factored during the year ($138.9-$112.9) came at the end of the fourth quarter and was still outstanding at the end of the period, adjusted DSOs would have risen by only about a day. Therefore, we are not overly concerned about receivables at this point.

Altria (MO)

Today's BUD Results Boost Chance of a Write-Down

We aren't going to explore all of Altria (MO) again today – but wanted to point out that Anheuser-Busch Inbev reported weak results today seeing lower EBITDA, lower margins, and weaker volumes in North America and Asia. BUD further cited higher raw materials costs and a 10% decline in EBITDA for 1Q20. It still is highlighting that it wants a ratio of net-debt to EBITDA of 2.0x vs. the current 4.0x. That may not mean another dividend cut, but it probably is not increasing by 100% to the level when MO acquired it any time soon.

Altria is carrying the value of its stake in BUD at $18.1 billion from December 31, 2019 even though the actual value of the stock was only $16.1 billion on that day. The value is growing faster as they are recording earnings at close to twice the level of dividends received. They did not take an impairment as they regarded the changes at BUD being temporary and the company would recover volumes and improve results. That is why they did not take a write-off in 2018 either when the carrying value of the investment was $17.7 billion against the actual value of the stock of $13.1 billion pointing to a plan for recovery.

We think two problems exist now for MO, which boost the risk of a write-down here. First, the stock is now down another 25% since the start of the year (that's not all coronavirus). The carrying value of $18.1 billion against the actual value $12.1 billion is a very pronounced difference. Second, BUD is not laying out guidance for material improvements in cash flow and operations. In fact, they noted today that they completed the synergy gains from merging with SAB in 3Q19.

DENTSPLY SIRONA (XRAY)

Patterson and Schein Inventory Drops May Predict Weakness for XRAY

We wrote DENTSPLY SIRONA (XRAY) on January 10, 2020 and warned that XRAY's margin gains of late could be jeopardized if its distributors reduce inventory as that should quickly back up on XRAY. Henry Schein saw 4Q inventories fall almost 3 days to 70.2 DSIs. They are falling y/y and sequentially. Patterson saw

DSIs rise from 3Q, which is normal historically, but decline 1.2 days to 69.1 y/y. It appeared to us that XRAY was carrying too much inventory after 3Q at 123 days and the distributors preferred to be under 70. The drops by the distributors may be an issue for XRAY results and guidance next week when it releases results on March 2.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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