BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

March 19, 2020 | www.btnresearch.com

Contents

Verisk Analytics (VRSK) EQ Review p. 1

Hanesbrands (HBI) 4Q19 Update- Maintain NEUTRAL p.12

Updates on Some Existing Ratings After Market Action (CAG, MDLZ, M, STWD, T, ARCC, LYB) p.20

Verisk Analytics (VRSK) 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 VRSK with a 4+ (Acceptable) rating.

We do not have a high degree of concern with VRSK's accounting quality. We do believe the period over which it amortizes developed software assets is unrealistically long. Also, the adding back of the amortization of intangible assets along with acquisition earn-outs to non-GAAP results distorts that measure as a true picture of VRSK's earnings profile, but this is a common problem among technology companies. Acquisitions are a key part of the company's growth strategy, but there is organic

growth without the acquisitions and cash flow covers the dividend, buyback, and acquisition spending in a typical period.

More specifically:

- The largest asset in the property, plant and equipment category is internally developed software which the company amortizes over 3-7 years. However, comparing software amortization to the average gross balance of capitalized software development costs indicates an effective amortization period of over 6 years. (Note that it amortizes purchased third party software over 3 years.) Given the speed of technological advancement, we doubt that code written today will still be adding a great deal of value to the company's operations in 6 years without considerable investment to keep it current. We estimate that if the company had cut its amortization period of developed software to 4 years, it would have taken about 31 cps off the 2019 non-GAAP earnings figure of $4.38.

- The company's acquisition strategy has resulted in a sizeable intangibles balance. It amortizes the acquired technology portion of the intangibles balances over 7 years. Again, this seems unrealistically long. Cutting the amortization period of acquired intangible technology assets to 3 years would have boosted 2019 intangible annual amortization expense by 43 cps.

- Like most of its technology peers, VRSK adds back intangibles amortization to non-GAAP EPS. For 2019, non-GAAP net income of $729 million had $109 million of after-tax intangibles amortization added back. This distorts the true earnings picture of the company, but we note that this is not as pronounced as some companies we see where half of non-GAAP earnings evaporate without intangibles amortization added back.

- VRSK's acquisitions regularly include contingency components whereby VRSK makes additional payments to the seller if the acquired operations meet certain performance targets. VRSK adds these "earn-outs" back to non-GAAP earnings. The amounts are volatile with some quarters having none and some accounting for 10-15% of non-GAAP earnings. While we agree that some sort of adjustment for these larger amounts is necessary when analyzing core growth rates, we caution analysts not to completely dismiss these amounts as they represent real cash investments.

- While the Energy and Specialized Markets segment accounts for only about a quarter of sales, acquisitions have driven goodwill related to the segment to more than 60% of the total company goodwill balance. The fair value of these assets is reviewed for impairment regularly with the valuation based on estimates of revenue and EBITDA assumptions years into the future. The valuation of the Energy and Specialized Markets segment was cited as a critical audit matter in the 10-K which simply means it is a key point of valuation for the company that is heavily reliant on estimation. The 2019 10-K does not caution investors about a small cushion between fair value and carrying value which would ordinarily make this a non-issue in our minds. However, given the rapid deterioration in the energy markets, it is possible that future goodwill valuation could lead to an impairment charge.

- Lower stock compensation expense added about a penny per share to EPS growth in the 12/19 quarter. This is not a material issue, and we would complement the company for not adding back stock compensation expense to non-GAAP results as many of its peers do.

Company Description

VRSK's origins go back to 1971 when the Insurance Service Office (ISO) began as a non-profit advisory and rating organization consisting of an association of insurance companies gathering statistical data and other information from the insurance markets. The original purpose was to develop solutions to help insurance companies build and manage programs and product offerings. In 2009, ISO went public as Verisk Analytics.

Through a series of acquisitions, the company has expanded its services into other insurance-related functions such as data analytics, catastrophe modeling, and fraud prevention. Also, the company has built an Energy and Specialized Markets segment that provides data and analytics to natural resources companies, as well as its Financial Services Segment which provides competitive benchmarking, decision algorithms, and analytic services to financial institutions, payment networks and processors, alternative lenders, regulators, and merchants. For 2019, insurance accounted for 71% of total revenue, Energy and Specialized Markets accounted for 22% and Financial Services 7%.

Revenue Recognition and Cash Flow Profile of Acquisition Strategy

VRSK's product and services are generally sold on a subscription basis where customers are invoiced either annually, quarterly or monthly. Revenue is recognized on a ratable basis over the contract term, generally ranging from 1-5 years. As a result, the company's cash receipts are front-loaded and growth in revenue leads to an immediate growth in cash flow. As shown in the following table, VRSK carries a substantial deferred revenue balance representing the cash received ahead of being recognized as revenue on the income statement:

	12/31/2019	12/29/2018	12/30/2017
T12 Revenue	$2,607	$2,395	$2,145
Deferred Revenue	$440	$383	$385
Deferred Revenue Days	61.6	58.4	65.5

Deferred revenue is greater than receivables in most periods:

	12/31/2019	12/29/2018	12/30/2017
T12 Revenue	$2,607	$2,395	$2,145
Accounts Receivable	$442	$356	$346
DSOs	61.8	54.3	58.8

Note that the jump in DSOs is impacted by both acquisitions and divestitures.

As we will discuss in a later section, VRSK regularly makes acquisitions as part of its growth strategy. The following table shows a history of deals made over the last three years:

2019	
Flexible Architecture & Simplified Tech- 12/23/2019-	$192.4
Commerce Signals- 12/5/2019	$3.8
Genscape- 11/5/2019	$353.2
BuildFax - 10/10/2019	$40.4
Property Pres Wizard - 8/28/2019	$15.0
Keystone Aerial Surveys - 7/31/2019	$29.8
CaaS Business of and Enterprise App Provider	$69.1

2018	
Rulebook- 12/14/2018	$86.5
Validus-IVC Limited - 6/20/2018	$46.1
Business Insight Limited - 2/21/2019	$18.0
Marketview Limited	$4.0

2017	
PowerAdvocate - 12/29/2017	$200.4
Service Software - 12/22/2017	$6.8
Rebmark Legal Solutions - 11/9/2017	$2.5
Lundquist Consulting - 8/31/2017	$150.6
Sequel Business Solutions - 8/23/2017	$320.3
G2 Web Services	$112.0
"Aerial Imagery Acquisitions" - 6/30/2017	$28.1
MAKE Consulting A/S - 5/19/2017	$16.9
Fintellix Solutions Private Limited - 3/31/2017	$16.9
Emergent Network Intelligence Limited - 2/24/2017	$6.1
Healix International Holdings Limited - 2/16/2017	$52.4
Arium Limited - 1/21/2017	$1.9

In an acquisition-heavy year such as 2019, free cash does not cover acquisitions, buyback, and dividend.

	12/31/2019	12/29/2018	12/30/2017	12/31/2016
T12 Operating Cash Flow	$956	$934	$744	$578
T12 Capex	$217	$231	$184	$157
T12 Free Cash Flow	$740	$703	$560	$421
T12 Dividends	$164	$0	$0	$0
Dividend % of Free Cash	22.1%	0.0%	0.0%	0.0%
T12 Net Stock Repurchases	$300	$439	$276	$327
Cash Flow after Buyback	$276	$265	$284	$94
T12 Net cash for acquisitions	$704	$153	$915	$74
Cash After Buyback and Acquisitions	-$428	$112	-$631	$20

Note that for 2019, the bulk of the acquisition spending was in the fourth quarter which means the cash spent on acquisitions was fully reflected in the above numbers while the acquired operations generated less than a quarter of cash flow.

VRSK does generate organic growth without acquisitions as shown in the following table which compares reported revenue growth to growth adjusted for acquisitions and divestitures:

	2019	2018	2017
Reported Revenue Growth	8.9%	11.6%	7.5%
Excluding Acquisitions, Held for Sale and Disposition	6.2%	6.5%	4.5%

The fourth quarter 2019 acquisition spree drove debt up to 2.4 times adjusted EBITDA and leverage has ranged in the 2-2.4 range over the last two years.

Amortization Period of Software Development Costs Appears Long

VRSK spends heavily on developing its software primarily for internal use. While the company does sell software as a service with some of its products, internally developed software is vital to the company's model as efficiently collecting and processing enormous amounts of data is the bulk of the company's s value add. The largest component of its property, plant, and equipment balance is the $400 million "Software Development Costs line." According to its accounting policy discussion in the 10-K, it amortizes software development costs over 3-7 years. However, if we take the annual amortization of software development costs for 2019 and compare it to the average gross balance of software development costs, it appears that the effective useful life over which the amortization is calculated is over 6 years:

	2019
Amortization of Internal Use Software Development	$100
Amortization of Software Developed for Sale	$13
Total Internally Developed Software Amortization	$113
Avg Gross Capitalized Software Development Costs	$714
Implied Amortization Period	6.3 yrs

6 years is longer than most amortization periods we see for such capitalized developed technology costs. Intuitively, given the rapid pace of technology, we doubt much of the code being written today will still be adding value more than 6 years from now without significant spending to keep it updated. At the very least, we believe it would take an accelerated amortization schedule to most closely reflect actual experience rather than the straight-line method employed by VRSK. Interestingly, VRSK amortizes purchase software over 3 years.

Software development amortization currently costs approximately 54 cps. To put this in perspective, if the effective amortization period was reduced to just 4 years, it would result in a 31 cps increase in developed software amortization expense which represents about 7% of 2019's non-GAAP EPS of $4.38.

We note that the company has begun to pare back its capital spending which fell to 8.1% of revenue in 2019 from 9.6% in 2018. As such, it projected in the fourth-quarter conference call that fixed asset depreciation and amortization will decline to $170-$180 million in 2020 from $186 million in 2019.

Amortization of Intangible Assets

In most cases, VRSK books the majority of the fair value of its acquired companies under goodwill with most of the balance recorded as an amortizable intangible asset. The goodwill is never amortized thus erasing the impact of that cost on future earnings. Intangible assets are amortized to earnings and the following table shows the gross balance of the intangible asset categories and the weighted average useful lives of each for the last several quarters:

Weighted Average Useful Lives of Intangible Assets

	Gross Balance at 12/19	12/31/2019	9/28/2019	6/29/2019	3/30/2019	12/29/2018	9/29/2018	6/30/2018
Technology	$519.2	7	8	8	8	8	8	8
Marketing	$265.3	16	16	16	16	16	17	16
Contract	$5.0	6	6	6	6	6	6	6
Customer	$901.2	13	14	14	14	14	14	14
Database	$484.6	19	19	19	19	19	19	19
	$2,175.3							

On the positive side, the amortization periods for acquired intangibles have remained very stable over the last two years. However, the company's acquired technology assets, which likely are made largely of investments in software, are being amortized over 7-8 years. As we discussed in the section above, we believe the company's effective amortization period of internally developed software costs of more than 6 years is too high to accurately reflect how long these assets are generating value for the company. We would argue that the useful life of acquired assets should be even shorter as the technology likely requires additional investment to integrate into the company's systems and some will likely be abandoned for all practical purposes.

Amortization expense associated with acquired technology assets currently amounts to 33 cps. If the effective amortization period was reduced to 3 years from 7, it would cost an additional 43 cps.

Adding Back Amortization of Intangibles Distorts Non-GAAP Numbers

As we noted in the previous section, the amortization of acquired technology assets appears unrealistically low. However, like many technology companies, VRSK adds back amortization of acquired intangibles to its non-GAAP earnings figures. In 2019, non-GAAP net income of $729 million had $109 million (after-tax) of intangibles amortization expense added back. As we have pointed out with several similar companies, we view this as a major distortion as the company would have spent cash to develop those assets itself had it not acquired them, either in the form of internally developed technology or through the costs to acquire contracts. Management has implied that internally developed technology is a major component of capital spending, so these amounts represent very real cash expenses the company would have otherwise occurred if the cash has not been spent to acquire it. We do note that the distortion is not as large for VRSK as it is for some companies we have looked at where half or more of non-GAAP earnings evaporate if the amortization expense is taken out.

Adding Back Earn-Outs Also Distorts Non-GAAP Results

Also on the non-GAAP adjustment front, we note that the company adds back acquisition-related earn-outs in its non-GAAP results. The following table shows these adjustments versus non-GAAP EPS for the last eight quarters:

	12/31/2019	9/28/2019	6/29/2019	3/30/2019
EPS Impact of Acquisition Earn-Outs	$0.16	$0.16	$0.04	$0.06
Non-GAAP EPS	$1.13	$1.12	$1.10	$1.03
% of Non-GAAP EPS	14.0%	14.5%	3.7%	5.8%

	12/29/2018	9/29/2018	6/30/2018	3/31/2018
EPS Impact of Acquisition Earn-Outs	$0.01	$0.00	$0.00	$0.01
Non-GAAP EPS	$1.04	$1.08	$1.05	$0.94
% of Non-GAAP EPS	1.3%	0.1%	0.1%	1.6%

Most of the company's acquisitions contain a contingency component whereby the company has to pay additional amounts if the acquired company meets certain pre-determined performance targets. We do not disagree that analysts should make their own adjustments in periods such as the 12/19 and 9/19 quarters in which the earn-outs materially distort reported growth rates. Some may even view these payments as a good sign as they indicate that the acquired operation is performing well. However, we caution analysts from totally ignoring these costs as they are very real cash payments that the company is incurring that is essentially being ignored by the non-GAAP results.

Energy and Specialized Markets Goodwill

Despite accounting for less than a quarter of revenue, acquisitions have resulted in the Energy and Specialized Markets segment accounting for more than 60% of the goodwill on the company's balance sheet as shown in the table below:

	2019	2018	2017
Insurance	$999	$834	$749
Energy and Specialized Markets	$2,390	$2,055	$2,150
Financial Services	$476	$473	$470
	$3,864	$3,362	$3,369

As we mentioned above, this goodwill is not amortized so that portion of the cost associated with the acquisition never impacts the income statement. However, the goodwill is subject to annual impairment review and the Energy and Specialized segment goodwill was specifically cited as a critical audit matter in the 2019 10-K. This does not mean that auditors found anything wrong in the reporting of goodwill, but rather indicates it is a material matter relating to the valuation of the company which is reliant on a particularly large degree of estimation. Consider the following comment from the auditor's letter in the 10-K:

> *"Given the significant judgments made by management to estimate the fair value of the reporting unit within the Energy and Specialized Markets reportable segment including management's judgments in selecting significant assumptions to forecast future revenues, EBITDA margins, and the discount rate, as well as the selection of revenue and EBITDA multiples, performing audit procedures to evaluate the reasonableness of management's estimates and assumptions for the reporting unit within the* ***Energy and Specialized Markets reportable segment required a high degree of auditor judgment and an increased extent of effort, including the need to involve our fair value specialists."***

The company did not mention that the cushion between fair value and carrying value was narrow in the goodwill and intangible footnotes. Therefore, we would not have mentioned this issue at all were it not for the recent carnage in the energy sector. Below is a description from the 10-K regarding the services offering by the Energy and Specialized Markets segment:

> *"We provide research and consulting services focusing on exploration strategies and screening, asset development and acquisition, commodity markets, and corporate analysis. We offer consultancy in the areas of business environment, business improvement, business strategies, commercial advisory, and transaction support."*

Given that most exploration companies have slashed their capex budgets for 2020 due to the plunge in oil prices, we would not be surprised to see significantly below-plan results from this segment. This could materially impact the fair value estimates for the associated goodwill and therefore, a write-down in the value of the goodwill does not seem out of the question in our minds.

Lower Stock-Based Compensation Added a Penny

Stock compensation expense fell by about a penny per share in the 12/19 quarter as shown below:

	12/31/2019	9/28/2019	6/29/2019	3/30/2019
Stock based compensation	$6.300	$8.800	$18.400	$9.200
EPS Impact of Difference in Stock-Based Compensation	$0.010	$0.007	-$0.035	-$0.002

	12/29/2018	9/29/2018	6/30/2018	3/31/2018
Stock based compensation	$8.400	$10.300	$11.000	$8.800
EPS Impact of Difference in Stock-Based Compensation	-$0.004	-$0.007	-$0.010	-$0.011

This is not a material issue at present. *We also want to compliment the company on not adding back stock compensation expense to its non-GAAP results as is common in many of the company's technology peers.*

Change in Long-Term Incentive Compensation Will Cause a Shift in Expense

Just as a housekeeping matter, we note that the company cautioned investors in the conference call that a change in the timing of long-term incentive compensation will result in a material shift in expense recognition in the first half of the year:

> *"The company recently changed the timing of the grant of long-term incentive compensation into the first quarter from the second quarter previously. This timing change aligns Verisk with a greater market and more closely times employee compensation with calendar year results.* ***The resulting impact will be increased expense of $10 million in the first quarter related to long-term incentive compensation, but that will reverse to a benefit in the second quarter."***

Hanesbrands (HBI) 4Q'19 Update
Maintain NEUTRAL
Maintain EQ Rating of 3+ (Minor Concern)

We maintain our NEUTRAL rating and our EQ Rating of 3+ (Minor Concern) indicating the situation is. Investors could be attracted to the 6% dividend and a free cash flow yield of 11% based on current prices. Some adjustments in working capital have likely inflated that free cash flow yield by 200-300bp in our opinion. Also, many of our working capital concerns appear to have corrected and debt levels have been reduced to 2.9x adjusted EBITDA. Margins have also rebounded and while innerwear continues to suffer from retail stores closing – that part of the story is not surprising anyone in our view.

In general, there are likely some better growth stories out there given current prices. Several of the negative issues have corrected in our view and the dividend appears well covered. We would not argue with anyone who does see this as a buy. The catalyst to follow there is the FIFO inventory that has been penalizing HBI due to slow inventory turn and commodity costs falling – may become more benign and allow the company to see some margin expansion:

- Securitization of receivables has gone to zero. We see that as a positive. Securitized A/R were always on the balance sheet and did not impact cash from operations or DSOs. They may still use this mechanism going forward, which could boost cash flow in the financing section of the cash flow statement.

- Adjusting for the inflows and outflows of securitization in free cash flow, HBI's adjusted free cash flow is lower by $162 million than it first appears. But starting 2020 at zero, it could only rise going forward.

- HBI also sells receivables and does not disclose the amounts. There are signs that this happened in a large way in 2019 and positively boosted cash from operations and free cash flow. Discounts on receivables sold are linked to LIBOR which fell throughout 2019 – yet the level of fees paid rose y/y. Also, from 3Q to 4Q, HBI saw a $195.5 million positive cash flow swing from receivables.

- DSOs look lower than normal both y/y and sequentially. We think selling receivables could be the issue here and it is difficult to completely assess DSOs. Based on the swing in A/R in the quarter, DSO of 42.5 could be 10 days higher.

- Inventories have improved, which reflects some new product roll-outs being completed and lower commodity costs coming into raw materials. The inherent problem of simply having a slow turning total inventory balance remains with DSIs at 166 days.

- FIFO accounting is likely masking some potential margin gain at HBI. The company is touting that price hikes for innerwear in early 2019 are now showing up as higher margins and total gross margin rose 130bp in 4Q19 and operating margin up 30bp. The raw material prices have been declining for over a year now.

- FIFO has HBI selling the oldest raw materials and the company is reporting that higher raw material costs have remained a headwind throughout 2019. If the innerwear is starting to work past this as it did in 4Q19, this could be an area for upside surprise for HBI. 50bp of margin is worth 8-cents in EPS.

- Other positives – the company finally started to boost advertising again last year, Activewear adjusted for the loss of Target is still growing, the bulk of intangibles are on the growth parts of the company of Activewear and International.

- Other negatives – Innerwear sales continue to lag and that is expected to continue and we still wonder how much of the International sales growth is due to opening new stores and initial stocking. As the base grows, HBI will rely more on replacing sold merchandise for growth.

Receivable Concerns Have Mitigated on Securitization – On A/R Sales We are Less Certain

The company still has its securitization program we discussed in the February 14, 2019 EQ report. However, at the end of 2019, it had no balance on it. Under this program, the receivables stay on the balance sheet and the cash impacts run through the financing section of the cash flow statement:

Securitization	2019	2018	2017	2016
Borrowings	$246.4	$213.3	$373.6	$238.1
Repayments	-$408.0	-$176.9	-$293.0	-$388.7
Net Cash Flow	-$161.6	$36.4	$80.7	-$150.6

These securitized receivables do not distort DSOs and do not impact cash from operations. This source or use of cash flow only flows through the financing section. The current balance is zero. This is another area of debt that was paid down in 2019. One could argue that because the receivables are being used to generate cash flow – it should also be viewed as a source or use of operating cash flow too. Under that scenario, we would question if cash flow and free cash flow are as strong as they appear on the surface:

Securitization	2019	2018	2017	2016
Cash from Ops	$803.4	$643.4	$655.7	$227.0
Capital Spending	$101.1	$86.3	$87.0	$99.4
Free Cash Flow	$702.3	$557.1	$568.7	$127.6
Net Securitization	-161.6	36.4	80.7	-150.6
Adj. FCF	$540.7	$593.5	$649.4	-$23.0

Looked at this way, the free cash flow drops from $702 million to $541 million and the free cash flow yield on a $6.3 billion enterprise value falls from 11% to 9%.

The other issue that remains is HBI does sell receivables also. When that happens, it does remove the receivables from the balance sheet and that helps operating cash flow and it would influence DSOs. While HBI does not disclose the amount sold, there are two clues that there was a large sale of receivables in 4Q and during the year:

- In 2018, the company noted that it saw funding fees related to these sales rise from $6.1 million in 2017 to $9.6 million. It reported that $2.9 million of the increase was due to an increase of LIBOR in 2018 – and LIBOR did rise through the year and gained about 100bp. In 2019, the funding fees related to sales of receivables rose to $9.9 million. However, we know LIBOR fell over 100bp during the year and yet the fees were higher. That leads us to believe HBI sold more receivables than the year before.

- At the end of the 3Q19 – A/R was a consumer of cash flow for the first nine months of $170.3 million. By the end of 4Q19 – A/R was generating $45.2 million in operating cash flow for the year – a $195.5 million positive swing in 4Q. From 3Q18 to 4Q18, the swing was $166.8 million. There is a seasonal impact too, where receivables normally decline, but that 4Q19 was a very large move.

When we first wrote HBI as an EQ report in early 2019 – we thought a large sale may have happened in 4Q18 and resulted in a drop in DSOs of 5-days. It happened again in 2019 and the drop was larger:

	4Q19	3Q19	2Q19	1Q19
Sales	$1,751	$1,867	$1,761	$1,588
A/R	$815	$1,034	$1,012	$933
Sales y/y Growth	-0.8%	1.0%	2.7%	7.9%
A/R y/y Growth	-6.4%	-1.1%	3.9%	6.6%
A/R DSOs	42.5	50.5	52.4	53.6

	4Q18	3Q18	2Q18	1Q18
Sales	$1,768	$1,849	$1,715	$1,472
A/R	$871	$1,045	$974	$875
Sales y/y Growth	7.5%	2.7%	4.2%	6.6%
A/R y/y Growth	-3.6%	3.5%	4.1%	9.3%
A/R DSOs	44.9	51.6	51.8	54.2

	4Q17	3Q17	2Q17	1Q17
Sales	$1,645	$1,799	$1,647	$1,380
A/R	$903	$1,009	$936	$800
Sales y/y Growth	4.4%	2.2%	11.8%	13.2%
A/R y/y Growth	7.9%	4.9%	9.1%	10.9%
A/R DSOs	50.1	51.2	51.8	52.9

Just Using the 4Q Swing in A/R as a Proxy for Sold Receivables, the 4Q19 DSO May Be 10 Days Higher and 4Q18 About 8.6 Days Higher

There is nothing evil about selling receivables. But investors need to be aware that the company is producing cash flow from this source and DSOs are impacted. Also, the risk is that it becomes tougher to keep selling a larger total of receivables each year. That may be especially true with much of the growth here coming from foreign markets. Investors also face a risk if the receivable sales come in less in a given year as that would swiftly reduce cash flow. If we add a line to the table adjusting free cash flow for securitizations to include cash flow generated from receivables, the free cash declines further:

Securitization	2019	2018	2017
Cash from Ops	$803.4	$643.4	$655.7
Capital Spending	$101.1	$86.3	$87.0
Free Cash Flow	$702.3	$557.1	$568.7
Net Securitization	-$161.6	$36.4	$80.7
A/R change	$45.2	$10.3	-$31.7
Adj. FCF	$495.5	$583.2	$681.1

Now the adjusted FCF yield would fall under 8% without the receivable funding mechanisms. HBI would be starting 2020 with one positive in that the securitization trust is at a zero balance and would not consume cash this year. That alone could help the adjusted figure. What may have happened though is that the cash from selling receivables simply repaid the securitization line and both programs could be smaller in 2020.

These events within receivables are the difference between HBI having a payout ratio on the dividend of 31% of normally calculated Free Cash Flow and 44% adjusted for the receivable movements.

Inventories Have Improved – FIFO Margin Drag May Slow in 2020

HBI came into 2019 claiming that future sales releases for Champion in 2019 would result in higher inventory build-up. That happened and the levels have dropped back again, which we regard as a positive:

Inventory DSI	4Q19	3Q19	2Q19	1Q19
Raw Materials	7.3	7.8	9.0	11.2
Work in Prog.	11.9	10.8	14.2	16.1
Fin. Goods	147.3	148.0	164.4	183.6
Total DSI	166.5	166.6	187.6	210.9

Inventory DSI	4Q18	3Q18	2Q18	1Q18
Raw Materials	9.2	10.8	11.9	13.8
Work in Prog.	15.7	15.7	18.6	21.8
Fin. Goods	151.4	145.3	152.2	173.4
Total DSI	176.3	171.8	182.7	209.0

Inventory DSI	4Q17	3Q17	2Q17	1Q17
Raw Materials	11.6	10.6	12.4	15.1
Work in Prog.	20.3	16.4	18.1	22.3
Fin. Goods	136.1	132.0	151.9	179.5
Total DSI	168.0	159.0	182.4	216.9

Raw materials like cotton, natural gas, and liquids have been falling since mid-2018. The raw materials and work in progress show that they have been declining except during the ramp-up of early 2019 for Champion. The problem we see is HBI still turns inventory only about 2x per year and uses FIFO accounting. It should be seeing higher-priced goods rolling through cost of goods sold. The company complained that margins were restrained in 2018 and 2019 by higher raw material costs so that is still working through the inventory supply.

In the 4Q19 – the margins did pop a bit. This was due largely to price increases at Innerwear, more favorable price/mix at other units, and realizing some benefits of distribution restructuring. The company is giving guidance that it could see margins expand during 2020 and the inventory trends do support that forecast.

Adj Gross Margin	4Q	3Q	2Q	1Q
2019	41.4%	38.8%	39.0%	40.2%
2018	40.1%	39.2%	39.1%	40.1%
2017	40.1%	37.8%	39.5%	40.2%
2016	39.6%	37.6%		

Adj Op. Margin	4Q	3Q	2Q	1Q
2019	15.0%	14.9%	14.0%	10.7%
2018	14.7%	15.0%	14.3%	11.3%
2017	14.3%	15.0%	15.8%	11.6%
2016	15.9%	15.4%		

If investors want to look for reasons to be more bullish on HBI – look here. A 50bp gain in margin if the raw material headwind declines is almost $30 million in earnings and cash flow plus 8-cents in EPS.

Extra Positives

- Advertising rose last year. We noted that much of HBI's cost-cutting in recent years came from cuts to advertising, R&D, and 401-k contributions as well as moving pension cost below the operating income line adding 30bp to margins too. The cost-cutting in R&D continued, but we were pleased to see HBI boost advertising in 2019:

$ spent	2019	2018	2017	2016	2015	2014	2013
R&D Exp.	$51.5	$59.3	$65.5	$70.1	$62.3	$63.3	$51.3
Advertising	$163.8	$152.7	$157.4	$168.7	$182.0	$183.3	$161.5
401-k	$28.9	$25.8	$21.3	$26.4	$22.0	$22.9	$23.5

Basis Pts	2019	2018	2017	2016	2015	2014	2013
R&D Exp.	74	87	101	116	109	119	111
Advertising	235	224	243	280	318	344	349
401-k	41	38	33	44	38	43	51
total	350	350	377	440	465	506	511

- Active Wear adjusted for the loss of some Target business in 2019 is growing. The company reported that Champion sales adjusted for the loss of C9 in the mass market grew 14%. This loss was well-known, and the y/y comps will continue to show this in early 2020 – but the negative figures should mitigate through the year:

Sales Growth	4Q19	3Q19	2Q19	1Q19	4Q18
Activewear	-6.7%	-1.2%	10.5%	17.1%	13.5%

The loss in 4Q19 was below forecast and the remaining business may be doing better. We still think some of this is the result of initial stocking of new product which doesn't require sell-through to become sales at HBI, but it could top forecasts in this area in 2020.

- The bulk of the intangible assets here are related to the International and Activewear segments, which are growing sales – but have some FX and raw material pressures.

Extra Negatives

- Innerwear sales continue to fall. This is due to lost market share and retailer locations closing. That has been a long and well-known trend. But this is still 33% of sales and 43% of segment income:

Sales Growth	4Q19	3Q19	2Q19	1Q19	4Q18
Innerwear	-4.1%	-3.5%	-2.3%	-3.1%	-0.1%

The -0.1% in 4Q18 was likely helped by the -6.9% in 3Q18. Guidance is for an ugly 1Q20 of -5.5% to -7.5% based on more store closings and tougher comps from higher shipping levels in early 2019. The company expecting it to improve after that and is noting that margins have improved at this point.

- While International sales are still growing by opening new stores, we expect the law of big numbers to start impacting results as the existing base of stores become repeat business beyond initial stocking. Another sign of some maturity is HBI had an unexpected $3 million bad debt loss from an Australian retailer last quarter.

Some Quick Updates on Current Recommendations after the Recent Market Action

Sealed Air (SEE) – Maintain SELL

1) Diversey sale has a claw-back liability if it cannot hit margin targets. Buyers filed a $49.2 million claim against SEE late in 2019, which SEE is disputing. There is also a receivable on SEE's balance sheet for $11.6 million from the deal. This puts 25-cents and 6-cents at risk for EPS.
2) Total EPS Growth in 2019 was 32-cents. It gained 39-cents from price/cost spread that allows it to recover rising commodity costs from customers. However, the goal is still to have it net to zero over time. With commodities now falling, that should be an earnings headwind. Another 9-cents came from lower share-count following the Diversey sale, share count is expected to rise in 2020.
3) Litigation and investigations are increasing.
    a. SEC inquiry has expanded from income taxes, financial reporting, and disclosures to include the process of selecting its auditor from 2015-18 and the independence of that firm.
    b. North Carolina continues to pursue an investigation on the termination of the CFO and auditor selection.
    c. Three new shareholder lawsuits focus on management issues for misleading statements for asbestos liabilities, tax deduction issues, stock repurchases, insider stock trades, and want to inspect books and records.
    d. The IRS is still disputing the company's $1.49 billion deduction, which is another $0.5 billion risk facing SEE vs. its free cash flow of about $0.3 billion.

Conagra Brands (CAG) – Upgrade to NEUTRAL

1) CAG's quarter ended in February and it cut forecasts leading into that. Since then, the coronavirus has created a rush to grocery stores for long-lived food such as canned spaghetti and frozen dinners. The country is

filling its pantry inventory in a huge way based on considerable anecdotal evidence and price has not mattered much in the last two weeks. We expect CAG to boost guidance at the end of March due to this surge in sell-through.

2) One of our biggest concerns was that inventory levels appeared too high as new products were being rolled out. That would normally have led to greater mark-downs. CAG may have survived that with the panic buying and this risk may be largely over when results are released.
3) After a stronger than expected 4Q ends in May, we expect pricing pressure to return and set the company up for tough comps, which is seldom a good thing for CAG, and we will reevaluate.

Mondelez (MDLZ) - Maintain SELL

1) MDLZ owns 191.6 million shares of KDP that was worth $5.1 billion a couple of weeks ago vs. $3.8 billion now. KDP relies heavily on providing factoring for its suppliers to allow it to stretch payables to an incredible 233 days. If that unwinds, KDP could have a liquidity issue and the value of its intangibles could be impaired.
2) MDLZ itself has been generating cash flow from working capital and free cash flow is trailing dividend and share repurchases already.
3) Latin America and FX skews results. Actual growth has been anemic. There is a possible upside surprise for the current quarter giving panic shopping, but that will be tough to maintain, and the company was already benefiting from initial stocking.

Macy's (M) – Maintain BUY

1) It's too cheap at this point at move to Neutral at 3x EPS. 25% of sales are now online, and 1Q guidance already called for considerable disruption from new department build-outs and supply chain improvements. That disruption may accelerate while shoppers are not in physical stores. The current situation should not impact 3-year forecasts that call for $1.5 billion in cost savings based on already tested and verified programs.
2) With foreign flights banned, we should see the bottom of International travel and thus their higher dollar and higher profit shopping. That has been a weak

area in recent years and setting the level at $0 in some quarters this year should allow only for improvement.

3) The company's liquidity should allow it to maintain the dividend (it just paid one last week). However, we would expect current conditions to create a good excuse to cut the dividend (now at a 22% yield) to further enhance the balance sheet. We think that is priced in. The dividend consumes $466 million vs. the capital spending budget of $1 billion so that would free-up cash if they want to accelerate more of the spending in 2020.

Starwood Property Trust (STWD) – Maintain BUY

1) STWD's EPS rises as interest rates fall due to putting interest floors on all 2019 CRE loan originations. EPS still increases if rates rise as well as it fixed more of its financing. Also, 4Q was heavily backloaded for key units and did not realize a full period of interest income that is occurring for 1Q20. Both will drive EPS higher.
2) STWD's property unit is heavily weighted to medical and apartments. The apartments are for affordable housing where government programs support the rent and rent can increase but not decline. It has boosted its cash yields from that area by locking in lower borrowing costs.
3) Its servicing portfolio works with troubled commercial mortgages to restructure and refinance and it makes money in poor times, so income could grow there.
4) STWD does extreme stress testing and maintains sizeable liquidity – after 4Q18, they judged their readiness if all property values fell 20% overnight and interest spreads widened 250bp. They found they could mark everything to market, LTVs on loans would be 80%, and they would have sizeable liquidity to take advantage of the situation when others could not. During 2019, this situation improved with the floors it put in on new loans. It came into 2019 with LIBOR falling 200bp projected to cost it 1-cent in EPS, it exited 2019 with a 200bp drop in LIBOR expected to add 20-cents to EPS. STWD also moved more financing off balance sheet with securitizations, reduced reliance on warehouse lines, repo market, and other short-term credit by boosting duration in several parts of the financing with fixed-term notes, securitizations, et al, which cuts margin call exposure and roll-over risks. Under new GAAP guidelines, their LTV is likely to fall under 60.

5) The company is already buying back shares at these levels. This is a misunderstood mortgage REIT in our view and is in many ETFs with more troubled companies and gets sold with other REITs in the ETF portfolio. At a 20% yield, this remains very attractive.

AT&T (T) - Maintain BUY

1) Sum of the parts justifies buy along with 6.5% yield. $32 stock price – half the business is communications with 5G turning on and is growing earnings via new FirstNet customers and families. Mobility is $30b in EBITDA and should be worth 8-9x, Warner does $10b and has traded above 10x EBITDA in its past, Business Wire at $10b, entertainment without TV (mostly broadband) is about $6b, Latin America is $0.5b – value all that at 6x. Assume Xandr is a zero as its EBITDA = corporate costs. Assume TV and new streaming are zero now. The company is worth $440-$470b less $150b in debt – that's $40-$44 stock price with streaming as a call option.
2) EPS is helped by lowering interest costs due to paying down debt, share repurchases are already happening, $1.5 billion in cost savings with half already realized, plus bundling streaming, broadband and wireless cuts churn. Every 1bp gain in churn is worth $100 million or 1-cent in EPS. That should all boost EBITDA in various units too.
3) Capital spending levels should decline at least $2 billion adding to rising free cash flow. At the same time, debt retirement will not be as large of a pressure going forward so shareholders will benefit from dividends and rising share repurchases. The company sees another $2 billion in cost reductions to help boost EPS and EBITDA by 2022 and will continue to add to cash flow with minor asset monetization.

Ares Capital Corp (ARCC) – Maintain BUY

1) Portfolio is high quality – only 3% exposure to energy and 2% to retail vs. 56% to healthcare, software, utilities, and commercial/consumer services. They deal with larger companies than competitors due to their size and the average EBITDA is almost $140 million that has been growing y/y for many years and 74% of loans are secured. ARCC has long tenure with most of its lending

customers and has avoided light/no covenant loans which have increased in the market in recent years.

2) Tailwinds remain as interest rate floors are kicking in as rates decline preserving their yield that had declined in 3Q19 and 4Q19. ARCC has considerable capacity to expand its portfolio as it has lagged behind its multi-year plan to boost leverage due to its "pickiness." Spillover income of 95-cents per share should continue to support the dividend that ARCC out-earns and lead to special dividends as well.
3) Historically ARCC has posted loss rates of less than half of junk bonds while earning higher spreads. It is one of the few BDCs that went through the financial crisis and remains the largest one. ARCC is selling at a discount to book value, room to grow yield spreads based on its built-in structure, and BDC rules that would require essentially all income to be distributed to shareholders. With EPS of 45-48 cents vs the dividend of 40-cents, ARCC can see 2-3 cents in additional EPS by boosting leverage to 1.1-1.15x equity (still below its long-term goal) and another 1-2 cents if Libor starts to reverse. If nothing else, the drag of Libor that has been 1-2 cents in 3Q19 and 4Q19 should be over from the interest rate floors on loans.
4) The balance sheet is also key. ARCC is limited to a debt-to-equity maximum of 2 to 1. ARCC is currently at 0.95 to 1. If you write off 5% of the investments – the ratio rises to 1.05x (assuming no other income comes in to boost equity), writing off 20% boosts the ratio to 1.54x. Coming out of 2019 – 55% of the debt was fixed with no maturities until 2022. In January, ARCC issued another $750 million note that could have the fixed debt at 65% of the total. The company has revolvers and credit lines of $5.6 billion now and likely is only using $2.4-$3.0 billion of that total given the new $750 million of 3.25% notes. There is ample liquidity here in our view.

LyondellBasell (LYB) – Maintain BUY

1) LYB has three drivers for its basic business – the first is the price spread for crude oil vs natural gas, which gives it a cost advantage over Asia in pricing. LYB needs oil prices more than 8x gas to have a cost edge. With gas at $1.65 – oil over $14 makes this work. LYB has the ability to use both gas liquids or oil-based naphtha to make its feedstocks, so a complete oil collapse doesn't put

it out of business. The huge edge of oil at 20-30x gas prices from prior years is not here – but it currently is about 14x.

2) The second is the overall economy – its products go into auto production, house paint, and fuel additives – those are likely more impacted by the current situation. However, LYB products also go into bags and packaging for consumer goods that people are panic buying, soap and gels, even medical applications. So, it's very broad-based and diverse.
3) The third is pricing for end products that is a function of inventory supply and operating capacity. Likely, both of these are working against LYB for 2Q and 3Q. New capacity had been coming online and the market was accepting it with higher demand (there are still issues with demand growing in a linear fashion while capacity grows in a stair-step that creates short periods of overcapacity and then under capacity). We still believe that the world's economy will restart shortly – but expect weaker pricing for LYB in the next couple of quarters.
4) We are keeping this a BUY because this company has been doing EBITDA of $6 billion or higher since 2012. It has been a very stable company with its diverse feedstock options, and often having some markets and regions being stronger than others. Essentially, it doesn't have to fire on all cylinders at once to make this work. Free cash flow also runs $4-$5 billion per year and much of that is returned to shareholders. It has continually reduced costs and has a high ROI target to expand or make acquisitions vs. buying existing stock.
5) The balance sheet looks strong with $12b in debt, $1b in cash and ST investments so about 1.7x EBITDA in leverage. The $4.20 dividend is a 10% yield and only consumes only about 30% of free cash flow. It looks amazingly cheap at under 4x EBITDA.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.