BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Homebuilders Impairment Potential (DHI, LEN, PHM, TOL)

We have EQ ratings on two Home Builders – DR Horton (DHI) and Lennar (LEN). We are lowering both to 3- at this time. One of the largest risks to a home builder is an impairment to its inventory and that risk level has increased with the coronavirus. We are also going to examine PulteGroup (PHM) and Toll Brothers (TOL) on just this risk for comparison. All four of these companies had a stellar start to 2020 and now three of the four have commented on a significant drop in buyers since late March. As a result, we think this is a very timely topic.

In addition, while we expect there to be some impairments during this time – there are several reasons why the enormous and recurring write-offs that occurred in 2006-09 may not be what is coming. Optimists like to say "it's different THIS time" and pessimists point to history to say "it's never different THIS time." In looking at the history of housing drops and recoveries both tend to be swift – we think the more apt phrase in talking about today vs. 2007-09 is "It was different LAST time and may NOT be THIS time."

- The rate of decline for the homebuilders on new orders has been very quick. Orders have gone from increasing at 20%-30% rates y/y to falling 50% in a week. Companies pulled guidance. They are still building (construction has not been widely shut down) and still completing new orders and sales.

- While people debate V, L or U-shaped recoveries to housing for how long this may take – looking back at 60 years of housing starts – there have been basically 9 quick drops and recoveries. Only 2008 was U-shaped. A recovery that largely absorbs current inventories and occurs in under a year should limit impairments.

- There are many moving parts to an impairment, but the key risk many do not understand is the charge-off can be much larger than the inventory levels suggest as the builders have to complete the full community build-out, which means they are going to continue investing cash in a potentially weaker deal than planned. They have to estimate the total cash flows coming in and the timing of them. In many ways it is like thinking a 10% hit to a portfolio is a small item, until you realize that it actually means 80% of equity is gone and requires a 40% capital raise.

- What really makes an impairment large for a home builder is declining home prices as it is trying to sell spec homes on its books and falling prices reduce the forecasted cash flows to value assets in inventory. Also, the cash flows are discounted to PV on a fairly high hurdle rate, so the longer time to realize proceeds shrinks the value of those assets in the forecasts too.

- In 2006, housing was already in decline for most of these companies and there were only modest impairments against very high inventory levels well into the housing bubble unwinding. Pricing had not collapsed in 2006. It wasn't until 2007-09 that the impairments became enormous. The companies were still running fast into an already slowing market.

- In this case of 2020, all were reporting higher orders and strong traffic literally the day before the economy was shut down. On the positive side, construction has not been turned off and continues at this time. Thus, contracted homes are still being completed. Pricing is holding up and one company has reported trends seem to be improving already on traffic. If these companies have

impairments on par with 2006 – we believe investors will be positively surprised.

- In looking at inventory situations now vs. 2006, we think adjusted for unit volume and pricing compared to actual inventory levels – Pulte and DR Horton look to be in solid shape compared to Lennar and Toll Brothers. In all cases, the fact that pricing is so strong may well limit inventory impairments further. LNR, PHM, and DHI have also seen very high gross margin recovery. The margins would need to fall to generate an impairment – which would likely take several quarters of weak pricing and that hasn't started yet.

- The companies that have reported since the shut-downs started talked extensively about how quickly they have delayed starting new construction and are completing what is under contract. That is key because it preserves liquidity. More important for impairment risk is it limits the supply of new homes and helps hold up pricing levels.

- The U-shaped recovery from 2008-12 is helping now – because the market has been undersupplied in new homes for many years. Normally, the market needs 1.3-1.5 million homes at equilibrium – it ran under 1 million for four years and only recently hit 1.5 million. There also are not wide-spread defaults and repossessed homes hitting the market to compete with builder inventory. Tight supply is holding pricing up too which again mitigates impairment levels.

Overview – Strong Sales until Late March and Building Continues in April

Homebuilding has normally been one of the largest swinging cyclical industries there is. The group has seen enormous swings in interest rates, unemployment, inflation over the years, and nearly everyone over the age of 10 has been through a few of these cycles:

These are US housing starts by month going back to 1959. These are in thousands of homes, so the equilibrium of 1500 represents 1.5 million housing starts. While people talk about long swoons in business and those are definitely visible in the historical data – there are several periods of very quick recoveries too. In fact, the only U-shaped recovery for housing starts was 2009-12. Most other recovery periods have been V-shaped and fairly quick ones.

What is interesting to us is that in the last two quarters, all of these companies were still seeing strong orders and building was brisk:

DR Horton	Mar 20	Dec 19	PulteGroup	Mar 20	Dec 19
y/y unit orders	20%	19%	y/y unit orders	16%	33%
y/y unit backlog	14%*	2%	y/y unit backlog	20%	20%
y/y unit deliveries	8%	13%	y/y unit deliveries	16%	2%

- DR Horton provided preliminary results for March 20 and the backlog was for 6-months not 3.

Lennar	Feb 20	Nov 19	Toll Bros	Jan 20	Oct 19
y/y unit orders	18%	23%	y/y unit orders	31%	18%
y/y unit backlog	2%	-4%	y/y unit backlog	9%	3%
y/y unit deliveries	17%	16%	y/y unit deliveries	5%	-1%

All of these companies are still building at this time in nearly all markets. Those that have made comments all talked glowingly about the start of March. They are all now expecting order rates to slow in April and May and cancellation rates to increase:

DR Horton April 7, 2020 –

> "***Economic fundamentals remained solid in the housing market throughout most of the second quarter of fiscal 2020, as interest rates on mortgage loans remained low, demand was strong*** *and there was a limited supply of homes at affordable prices across most of the Company's markets. During the latter part of March and into April, the impacts of the COVID-19 pandemic (COVID-19) and the related widespread reductions in economic activity began to adversely affect the Company's business operations and the demand for its homes.* ***The Company has experienced increases in sales cancellations and decreases in sales orders in late March and early April, compared to the weeks leading up to the pandemic."***

PulteGroup April 23, 2020

> "***The U.S. housing industry carried tremendous momentum into 2020, until the devastating effects of the COVID-19*** *pandemic began impacting the country," said Ryan Marshall, PulteGroup President and CEO. "As the coronavirus spread and state and local governments implemented various restrictions and stay-in-place orders,* ***we experienced a material slowdown in consumer traffic and sales activity beginning in mid-March.****"*
>
> *"Our reported Q1 order growth, however, is not reflective of current market conditions. In the first quarter,* ***net new orders were up more than 30% over the prior year for both January and February.*** *It's now old news when I say that with the virus spreading rapidly and governments implementing shelter in place restrictions, home buying demands slowed dramatically as March progressed."*
>
> *"To appreciate the magnitude of the slowdown* ***in the first full week of March our net new order exceeded 800 homes. In the final full week this number dropped to just 140. As a result, our March 2020 orders in total were down 11% from March of 2019. From orders being up 30 plus percent to being down 11% in just a few weeks*** *is unlike anything we have experienced before."*

Lennar March 19, 2020

> "*What* ***we have seen so far since the end of the first quarter is that new orders have continued to be strong. For the first two weeks, new orders were up 16%, exceeding plan in each of our operating regions and traffic in our Welcome Home Centers has remained relatively strong. Nevertheless, we have started to see a slowdown in traffic over the past several days,*** *while at the same time we have seen a higher conversion rate of traffic to sales as those coming out are now more serious buyers."*
>
> *"****As the economy slows, we expected our traffic will decline and we will see the corresponding slowdown in sales****. We've moved to an appointment only environment in most of our Welcome Home Centers and in all of our communities we tour only one family at a time to prioritize the safety of our associates and of our customers."*

The Mechanics of An Impairment – It Can Be Much Larger than Inventory Levels Would Portend

Inventory Impairments for homebuilders are different from other write-offs. In most cases, an asset has a fixed value on the balance sheet that either doesn't change – like goodwill, or is being sold, amortized, or depreciated and is getting smaller going forward. The future estimated cash flow is discounted to the present and is compared to the carrying value of the asset. In the case of most companies, inventory is a fairly short-lived item and it may not be the largest asset on the balance sheet. For home builders, inventory exceeds book value:

	DHI	LEN	TOL	PHM
Inventory	$11,899	$18,643	$8,198	$7,858
Equity	$10,503	$12,980	$4,705	$5,530
Inv/EQ %	113%	144%	174%	142%

The homebuilders have large inventory balances as simply a part of doing business. It can take years to acquire, plan, build, and sell an entire subdivision. The discount rates are large. Most of these companies use 12%-16% hurdle rates for assets under a year and up to 25% for longer ones. Also, unlike capitalized software that is amortizing over 3-years and may already be on the books for 30-50% of cost when

doing an impairment test – home builder inventory is getting larger – not smaller when the problems arise.

The future cash flow for the homebuilder is selling the house. When people are worried about impairment risk – the value of the future home is often going down. Also, buyers may walk away from deals on homes already under contract and construction. The buyer may forfeit money to the builder, but the builder may no longer find that selling that house takes 6-months rather than 2-months. A $300,000 home that is discounted back at 6-months at 16% is worth $15,000 less than one discounted back 2-months. Also, if the economy is weaker, the builder may need to cut the price to sell the house in 6-months. Cutting the $300,000 house's price by 10%, now cuts the value by $43,000 vs. the house being delivered in 2-months.

The builder also works to keep his costs down and economies of scale working. The company does not start building homes only when it has orders from buyers. It may have 20 homes with customers and there are another 8 lots in the immediate area – it will often start building on those lots too. There are multiple reasons such as keeping the crews busy – if it's too cold to pour concrete – those workers can hang drywall in other homes for example. **These are called spec homes (new builds without a buyer). The builder will actively seek to sell those spec homes also often telling prospects who want Model-C that there are two Model-C's for sale already under construction and they can have one in 6-8 weeks instead of 4-months.** However, when buyers vanish, the time taken to sell spec homes often lengthens too. **It is common for spec homes to make up 20% of the inventory at times. Thus, falling prices and longer times to sell – can impact much more of the inventory than customers simply walking away.**

Those are two ways to get an impairment from weaker sales caused by lower selling prices or longer lead times to make the sale. The third problem is what makes home building inventories even more prone to write-downs. The builder has the money spent thus far on the homes under construction listed as inventory on the balance sheet. However, to test for impairments, it has to estimate what the total remaining costs are to complete the construction and enable the homes to be sold. These costs can be significant but are not on the books. Yet, they can influence the size of the write-down in a huge manner. Here is an example:

A homebuilder believes it can sell 100 homes for $300,000 each over 18-months and each house will cost $250,000 to build. Ultimately – the equation should look like $30

million in revenue less $25 million in costs for a gross profit of $5 million. But the mechanics aren't as vanilla as that.

After 6-months, assume it has acquired the lots for 80 of the homes, has completed 50% of the construction on 20 homes, 25% on 20 other homes. It hasn't delivered any of the homes yet. So, inventory is carrying all the current investment to date:

6 months in	Inventory
80 lots at $30,000	$2,400
20 homes 50% built	$2,100
20 homes 25% built	$1,050
Total Inventory	$5,550

Many people think there is only $5.55 million in inventory at risk, but in testing for an impairment, the builder has to look at the future cash flows and the future building costs – there is another $18.45 million in future costs that are coming. Now what happens if the market declines and the builder forecasts that it will take 3-years not 18 months to sell all the homes and the average price will be $240,000. There would be an impairment test that looks like this:

	12 months	24 months	36 months	PV of Cash
Sale of 25 homes @ $275	$6,875			$6,875
Sale of 50 homes at $240		$12,000		$10,236
Sale of 25 homes $205			$5,125	$3,729
Current Inventory	$5,550			-$5,550
Cost to buy 20 lots	$600			-$600
Cost to complete 1st 40 homes	$5,250			-$5,250
Cost to complete 2nd 60 homes	$12,600			-$12,600
Estimated Cash Flow				-$3,160

This is a very simplistic example and we only discounted the numbers for 24 months and 36 months. In this case, the subdivision would have an impairment of $3.16 million even though inventory for it is currently only $5.55 million. And, that $5.55 million in current inventory is only 23% of the total estimated cost, but it is going to absorb 100% of the total project's adjustment.

The other issue to keep in mind is not only can the impairment become much larger than what people initially think – the company has to continue paying the sizeable remaining costs to complete homes and subdivisions. That is why you hear these companies talking about liquidity so much and trying to slow construction or lot acquisition where possible. In the case of some land deals, the company can walk away and forfeit deposits. On partially completed spec homes – it is often cheaper overall to complete the construction.

Where the Companies Stand Now Verses 2006-2009

We fully expect there to be some impairments. Actually, impairments happen all the time due to cost overruns, delays in construction, design changes – they just tend to be minor. The bigger aspects of large impairments tend to center more on having to complete spec homes and hold them longer periods as well as having to cut prices to stimulate sales.

The inventory levels are high for these companies – but looking back at historical levels, they do not appear as problematic now as the numbers would indicate:

- In 2006, most of these companies were already seeing a turn-down in sales off nearly record peaks and still had high inventories.
- Adjusting for the difference in home prices from 2006 to today and volumes, not all these inventories look too bad.
- In 2006, companies were still building – in April 2020, some have already announced plans to delay construction and wait to see how the economy reopens

PulteGroup	1Q20	2019	2009	2008	2007	2006
Homebuilding Inv	$7,858	$7,681	$4,940	$4,201	$7,028	$9,374
Gross Margin	24%	23%	9%	10%	13%	19%
Units Sold	5,373	23,232	15,013	21,022	27,540	41,487
Avg Price	$413	$427	$258	$284	$322	$337
Inventory Impairment			$751	$1,200	$1,600	$204

Pulte was on pace for selling about 8% fewer homes in 2020 than it was in 2007. It's price per house now is 33% higher than in 2007, yet it's inventory is only 12% higher.

The inventory level in 2007 was after two impairments of $1.8 billion and two years of declining business.

Pulte also slammed on the breaks to prevent more inventory build – from the April 23rd call:

- we have been successful in delaying well over 90% of the lots scheduled for purchase in the near term. We would hope to have similar success as and when we need to deal with contracted land positions scheduled to close in the future.
- In the rare situations where we have been unable to agree on some form of extension with the land seller, we have walked away from the lots and our pre-acquisition expense. In the first quarter, these charges amounted to only $4 million.

- we are working to intelligently slow land development such that it is more appropriately aligned with the current sales environment.

- We've also implemented strategies to limit the amount of capital we are investing in vertical construction. This includes contacting backlog customers and reconfirming their status before beginning construction of that sold unit. Having said that between our existing spec starts and an elevated cancellation rate, we have spec units in production that we are also moving on to a slower track. At quarter-end we had a total of about 3,100 specs in the pipeline of which almost 40% were early enough in the build cycle that we are able to suspend further construction.

Lennar	1Q20	2019	2009	2008	2007	2006
Homebuilding Inv	$18,643	$17,777	$4,088	$4,500	$4,500	$7,831
Gross Margin	21%	21%	16%	17%	14%	20%
Units Sold	10,313	51,491	11,478	15,735	33,283	49,568
Avg Price	$402	$400	$243	$270	$297	$315
Inventory Impairment			$373	$377	$2,409	$502

Lennar added CalAtlantic since the 2006-08 timeframe which sells higher-priced homes. Based on the numbers, its inventory is 4x the level of 2007 after a massive impairment and 240% of the 2006 level. Pricing is only up 28% and volume is setting new highs is up about 7% - that does not support the increase in inventories overall

in our view. Lennar is also working to limit more inventory build. From the March 19th call:

- We are working collaboratively with our strong relationships with national, regional, and local developers to activate a circuit breaker, pausing by extending the closing date of our land purchases.

- We've also slowed down the amount of cash we are investing in land development, and rephasing our developments to reduce the number of home sites developed at one time. Finally, we're also adjusting our start pace and further limiting the amount of spec inventory production in order to closely match new starts with new sales.

- We started a number of years ago, a soft pivot to lighter and shorter duration land position. And those shorter duration land positions will certainly not suffer the kind of impairments that we've seen in prior cycles.

DR Horton	1Q20	2019	2009	2008	2007	2006
Homebuilding Inv	$11,899	$11,282	$3,663	$4,683	$9,344	$11,343
Gross Margin	21%	20%	13%	11%	17%	24%
Units Sold	13,126	56,565	17,034	21,251	33,687	51,980
Avg Price	$301	$298	$205	$220	$244	$267
Inventory Impairment			$408	$2,485	$1,330	$271

DR Horton may be in the best shape looking at the raw numbers compared to 2006. Its pricing is up 13% and its volume looked to be up another 13%. Yet, its inventory is up only about 5%. The company has not commented much other than a short press release on April 7th releasing preliminary results for the quarter. It noted that cancellations have increased, and new orders have dropped as expected. It is also limiting land acquisitions and development spending and adjusting inventory levels – (that may mean working to sell spec homes).

Toll Brothers	1Q20	2019	2009	2008	2007	2006
Homebuilding Inv	$8,198	$7,873	$3,184	$4,127	$5,573	$6,096
Gross Margin	18%	20%	15%	21%	27%	31%
Units Sold	1,611	8,107	2,965	4,743	6,687	8,601
Avg Price	$799	$864	$568	$608	$751	$799
Inventory Impairment			$465	$645	$620	$152

Toll Brothers reported too early for this to be an issue at the time. We would be concerned that its buyers may be more dependent on savings with it selling homes that average $800,000 and may not be a function of buyers only paying via income. Also, inventories were up 34% from 2006, yet pricing is flat, and volumes are down.

Our initial conclusion is there will be some impairments. It is unlikely these companies can go from an environment of seeing sales orders rising at 15%-20% to falling 50% in a week and not having some inventory issues. If nothing else, it will take longer to sell the current subdivisions than initially forecast. However, efforts to slow the pace of new inventory growth should help limit the supply of new spec homes on the market too.

It appears that DR Horton and Pulte are in better shape to withstand the impact of coronavirus on inventory. We would point out that one of the positives in the past for DR Horton was its ties to Texas where energy prices may be a drag longer than the virus.

Several Other Reasons Point to Smaller Impairments – Supply Is Tight

The U-shaped recovery from 2008-2012 is still working for these companies because the country simply has not built many homes in recent years. In the US, there are about 300,000 homes destroyed each year from disasters, a new stadium being built, or are simply torn down for dilapidation or to clear land for a new home. Also, population growth requires about 400,000-500,000 homes per year. On top of that, there are people who own multiple homes either as rentals, vacation retreats, or they are in transition with divorce or moving. All of that adds up to the market needs 1.3-1.5 million new homes every year.

Looking at the housing start graph earlier in this report – the US has been under 1.5 million housing starts from 2008-2020. It was below 1.0 million starts until late 2014

– or about five years. That's with 320-330 million people. We didn't have 200 million people until 1968 or 250 million until 1990. Yet, the country never had periods of more than a month or two of starts below 1.0 million from 1959-2008.

What made 2008-12 so rough is many people were defaulting on mortgages and those homes were being auctioned at the same time the homebuilders were still trying to sell spec homes that were built in stronger times. The result was oversupply and lots of price cutting. In the tables showing inventory impairments – the gross margins are also listed. Those are adjusted for the impairments. Also, the average price of the homes sold by the builders is listed. So, Lennar saw prices fall 23% from $315,000 to $243,000 and gross margin lost 300-500bp. DR Horton saw prices fall 23% too from $267,000 to $205,000 and gross margins lost 700-1300bp.

Lennar and Pulte are posting higher gross margins now than 2006, and DR Horton is close. All of these companies are attributing some of their strong order growth in recent years to a lack of supply for low-priced homes on the market. Whether the coronavirus issues last 2-months or 6 months – there does not appear to be a flood of defaults coming where $200,000 homes were valued at $600,000 only 5 years later and new mortgages took out 125% of that $600,000. There are efforts to help people pay mortgages due to income loss as well.

As a result, the one big positive now is the builders may not have enormous competition for selling their spec homes. That also means pricing may not decline as much. In the example we did above to illustrate an impairment, the 20% change in average pricing played a big part of triggering a $3.16 million hypothetical impairment against a $5.55 million inventory level. If the change was only 10% and applied to all homes – the impairment would be only $822 million or 74% less. Also, lower competition may allow spec homes to be sold more quickly too which would further cut the size of the impairment.

Pulte pointed this out on their call about this downturn vs. others:

> "*Different than, I think other housing downturns typically there has been a buildup of supply which we don't have right now.* ***There's not a buildup on the resale side. There's not a buildup on the new side and so I would tell you that's largely why we've seen price continue to hold."***

Lennar agreed:

"if you think about where our gross margins are, let's say, that's about 21% and the impairment process considers selling and marketing expenses. So, it's around 6%. So, you're already with a 15% net margin as your starting point. So that's reasonably healthy, higher than the net margin that we had around that 2006 timeframe, give or take. So, there's no crystal ball, it's very early. But I do think that that higher bar is very helpful to us."

"You have to remember that when you start to look at impairing assets, there's a built in kind of shock absorber, or buffer between a reduction in the market and impairment and that is our gross margin. As you know, our gross margin has been robust and remained strong. ***You're also looking at inventory levels across the industry that have been defined by short supply and production deficit. And so, it's going to be some time before we were called on to raise the question of impairment*** *but with that said, it's possible."*

Compared to 2008, Other Positives Exist Today – Credit and Affordability

We think the lack of other people dumping houses at the same time the builders are selling is the biggest difference. But what made the last crisis worse is many people who would have been potential buyers – had just defaulted on a loan and didn't qualify to buy again. Or, if they went a subprime route, they faced very high interest rates and had to put more cash down. There was simply a shortage of buyers too.

In the current situation, interest rates are falling and home payments are coming down. While the market isn't 2005-07 again where they didn't even verify if the person was actually alive who was getting a mortgage, it's not 2009-10 either where people needed 30% down and a FICO score of 800 to get to loan. That is helping keep more prospective buyers in the game. As one of the managers on the Pulte call noted, affordability and pricing isn't really the issue – pricing has been holding up well so fall – the issue is people can't go outside and shop.

The questions here seem to be over how long the shutdown and lasts and how quickly things bounce back. Pulte noted that recent talk of reopening starting soon has already started to translate to more buyer interest, "We are starting to see some pretty positive trends in our traffic data just starting this week as we think more of

the -- I think because more of the country is talking about reopening. We've seen certain states already take action to reopen and I think some of the understanding and the fears around COVID-19 is starting to subside. We're seeing some positive traffic trends which I think bodes well."

Snap-on Inc. (SNA)
Maintain SELL

After a review of the 3/20 quarter, we maintain our SELL rating on SNA. While the company saw some areas of its business such as military, general industry, and trucking holdup well, other areas are facing more pressure. While mechanics are deemed to be essential workers and have been allowed to continue to work during the lockdown, people are driving their cars much less. Transportation data provider INRIX reported that total miles driven (including the increase in long-haul truck traffic) were down 38% for March21-27 versus February 22-28. There is a case to be made that miles driven will rebound quickly when the restrictions are lifted and may receive a boost from people being reluctant to fly. However, there is also a potential for more people to keep working from home and skip the daily commute. The medium and long-term outlooks are unclear.

Regardless of the long-term impact, much of the company's customer base (independent auto shops) has been facing increasing pressure from competition, complexity of new cars driving work to dealerships, plus the longer-term threat of electric cars. The extension of credit continues and there is evidence the customer base is more leveraged than it was during the last crisis. We note the quarter also received some one-time boosts from option accounting.

- Finance receivable days jumped by 35 as the balance rose while sales declined. Originations were up 1.2% which the company attributed to an increase in sales of big-ticket items.

- Management noted during the call that loss rates in 2008-2009 rose to 4%. The allowance for bad debts as a percentage of finance receivables is currently 4.1%. However, total contract receivables and finance receivable days have risen to 202 in 2019 from 100 in 2010. While some of this company-extended credit may have been replacing other sources, the fact that the rates on finance receivables are in the 17-18% range may indicate that the customers had nowhere else to turn and therefore much of this debt may be incremental leverage on customers' balances sheets. With potentially higher leverage and a decade of mounting secular pressure on their businesses, it remains to be seen if customer defaults will result in more charges for SNA.

- Stock-based compensation expense fell by approximately 9 cps in the 3/20 quarter. Evidence suggests this was due to the stock price decline leading to updated estimates for stock option exercises which resulted in artificially low compensation expense. This will represent a significant headwind in upcoming quarters if the stock recovers significantly and estimates are adjusted the other way. We discuss the accounting in detail below.

- The lower stock price also artificially boosted reported results by causing a larger number of shares to be excluded from the fully-diluted shares count due to their becoming anti-dilutive. This added another 10 cps to the quarter and, like stock-based compensation expense, will reverse when the stock price recovers.

How High Can Finance Losses Go?

We have documented in the past how much of SNA's sales growth has been driven by the extension of credit to both its franchisees (Contract Receivables) and its end customers (Finance Receivables). We will focus this discussion on finance receivables given they are by far the largest component of the company's credit portfolio and they appear to be the most at risk given their high yields (17.7% in the 3/20 quarter). These loans are made to both auto repair shops as well as industrial customers. It is logical to assume that the bulk of these loans are to smaller customers on a tight budget. We doubt major Honda dealerships and Lockheed Martin are paying credit card levels of interest to finance the purchase of their hand tools and diagnostic systems.

Despite the decline in sales in the quarter, the company's extension of finance receivables increased as seen in the following table:

	3/28/2020	12/28/2019	9/28/2019	6/29/2019
Sales	$852.2	$955.2	$901.8	$951.3

ST Finance Receivables	$514.3	$530.1	$533.5	$529.0
ST Finance Receivables Days	55.1	50.6	54.0	50.7
LT Finance Receivables	$1,101.9	$1,103.5	$1,084.7	$1,089.0
LT Finance Receivables Days	118.0	105.4	109.8	104.5
Total Finance Receivables	$1,616.2	$1,633.6	$1,618.2	$1,618.0
Total Finance Receivables Days	173.1	156.1	163.7	155.2

	3/30/2019	12/29/2018	9/29/2018	6/30/2018
Sales	$921.7	$952.5	$898.1	$954.6
ST Finance Receivables	$525.9	$518.5	$519.0	$514.4
ST Finance Receivables Days	52.1	49.7	52.7	49.2
LT Finance Receivables	$1,077.1	$1,074.4	$1,058.3	$1,051.3
LT Finance Receivables Days	106.6	102.9	107.5	100.5
Total Finance Receivables	$1,603.0	$1,592.9	$1,577.3	$1,565.7
Total Finance Receivables Days	158.7	152.6	160.3	149.7

Total finance receivables days of sales rose by more than 14 days versus the year-ago quarter due to long-term finance receivables rising while sales declined. The company noted that:

> *"Total loan originations of $255.6 million increased $3.1 million, or 1.2%, primarily due to a 1.1% increase in originations of finance receivables, and a 2% increase in originations of contract receivables, principally franchise finance. In the United States, extended originations were up 2% larger reflecting higher franchisee sales of big-ticket products."*

Clearly, the increase in finance receivables days of sales was not a result of a slow runoff of existing receivables but rather more from an increase in organizations. While the first two months of the quarter were strong, sales reportedly fell off in the last four weeks as the COVID-19 quarantine took hold, implying that the growth in the first two months was a result of an unusual, credit-fueled big-ticket activity.

We can already start to see the shutdown's impact on credit statistics in the finance receivables portfolio, although they are not severe at this point:

Finance Receivables	3/28/2020	12/28/2019	9/28/2019	6/29/2019

30-59 days past due	1.07%	1.16%	1.07%	0.95%
60-90 days past due	0.68%	0.71%	0.67%	0.61%
>90 days past due	1.23%	1.26%	1.19%	0.97%
Total past due	2.98%	3.13%	2.92%	2.53%
>90 Days and Still Accruing	0.97%	1.01%	0.93%	0.75%

Finance Receivables	3/30/2019	12/29/2018	9/29/2018	6/30/2018
30-59 days past due	0.85%	1.17%	1.08%	1.04%
60-90 days past due	0.58%	0.73%	0.74%	0.65%
>90 days past due	1.17%	1.23%	1.19%	1.00%
Total past due	2.60%	3.13%	3.00%	2.69%
>90 Days and Still Accruing	0.90%	0.96%	0.94%	0.76%

Total past due finance receivables as a percentage of the total rose by almost 40 basis points. Meanwhile, loss rates also crept up:

Finance Receivables	3/28/2020	12/28/2019	9/28/2019	6/29/2019
Charge-Off Rate	-0.94%	-0.90%	-0.77%	-0.83%
Recovery Rate	0.12%	0.11%	0.11%	0.12%
Net Loss Rate	-0.82%	-0.79%	-0.66%	-0.71%

Finance Receivables	3/30/2019	12/29/2018	9/29/2018	6/30/2018
Charge-Off Rate	-0.90%	-0.95%	-0.81%	-0.90%
Recovery Rate	0.12%	0.11%	0.10%	0.10%
Net Loss Rate	-0.78%	-0.84%	-0.71%	-0.79%

After a string of improving quarterly net loss rates, the 3/20 quarter saw a slight 4 bps deterioration. The company did not disclose charge-off and recovery data in the 2008-2009 SEC filings so we cannot make an exact "apples-to-apples" comparison. However, management was asked about the 2008 loss rates on the conference call:

Analyst:

> "Got it and last question, just remind us what – just going back to '08 through 2010, what the 60 day delinquency numbers went up to from a percentage standpoint and the losses – the total losses in the portfolio on a trailing 12 month basis. Thanks."

Aldo Pagliari:

"Scott. I don't have the exact delinquency numbers in front of me. But they would be not so dissimilar to what you're seeing today. **But the losses went up about 100 basis points. I think I mentioned earlier on the call, they hit a peak in a negative sense in Q4 of '09, and then moved from around 3% over the portfolio to around 4%**. And then they declined back to below 3% until recent times, so that gives you a range I guess or a feel for what it might be like."

In the table above, the quarterly loss rate of 0.82% corresponds to an annual loss rate of approximately 3.3% and loss rates eventually hit 4% in the Great Recession. Management also noted it would be quick to help struggling shops by extending the terms and providing other concessions.

We are not concluding that the current situation will play itself out like the Great Recession, but remember that many of these customers are small independent shops that have been struggling from competition, more reliable cars, and a move towards getting cars serviced at dealerships due to increasing complexity. In addition, SNA's own financials provide a clue that many of these customers may be considerably more leveraged than they were ten years ago. The following table shows total outstanding contract and finance receivables on a days of sales basis for the last ten years:

	2019	2018	2017	2016	2015

Sales	$3,730.0	$3,740.7	$3,686.9	$3,430.4	$3,352.8
ST Finance	$530.1	$518.5	$505.4	$472.5	$447.3
ST Contract	$100.7	$98.3	$96.8	$88.1	$82.1
LT Finance	$1,103.5	$1,074.4	$1,039.2	$934.5	$727.7
LT Contract	$360.1	$344.9	$322.6	$286.7	$266.6
Total Finance and Contract Receivables	$2,094.4	$2,036.1	$1,964.0	$1,781.8	$1,523.7
Days of Sales	202	196	192	187	164

	2014	2013	2012	2011	2010
Sales	$3,277.7	$3,056.5	$2,937.9	$2,854.2	$2,619.2
ST Finance	$402.4	$374.6	$323.1	$277.2	$215.3
ST Contract	$74.5	$68.4	$62.7	$49.7	$45.6
LT Finance	$650.5	$560.6	$494.6	$431.8	$345.7
LT Contract	$242.0	$217.1	$194.4	$165.1	$119.3
Total Finance and Contract Receivables	$1,369.4	$1,220.7	$1,074.8	$923.8	$725.9
Days of Sales	150	144	132	117	100

This highlights one of our original concerns with the company which is the degree to which sales growth has been driven by extending more credit to its customers. Some of the credit extended by SNA could very well have been replacing other forms of borrowing and therefore does not represent new leverage on the customers' balance sheets. However, given that these customers are paying 17-18% in interest to SNA to finance equipment indicates that they likely could not have received this credit anywhere else. Therefore, we believe it is a logical conclusion that a decent part of the new credit does represent incremental leverage for customers meaning that even if the economy returns to normal relatively quickly, loss rates on the portfolio could meet or exceed those experienced in the Great Recession.

SNA did increase its provision expense for finance receivables by $3.8 million in the 3/20 quarter along with an additional $5.2 million related to the adoption of ASU No 2016-13 which requires the company to forecast credit losses on a forward-looking basis rather than using just historical trends. However, it also only attributed $2.1 million of the incremental increase to the impact of COVID-19. (Massive revenue losses for a period of months leading to only $2.1 million on a $2 billion portfolio seems a little unrealistic.) The provision expense brought the allowance for bad debts to 4.1% of the finance receivables portfolio at the end of the 3/20 quarter which is presumably on par with losses suffered in the 2008-2009 time period. Still, with the

higher degree of leverage and the possibility of miles driven being suppressed for some time we would not be surprised to see higher than expected expenses out of the credit portfolio over the next couple of quarters.

Stock-Based Compensation Down Sharply

SNA enjoyed a sharp decline in stock-based compensation expense in the 3/20 quarter as seen in the following table:

	3/28/2020	12/28/2019	9/28/2019	6/29/2019
Stock-Based Comp Expense	$1.1	$5.1	$4.6	$6.8

	3/28/2020	12/28/2019	9/28/2019	6/29/2019
Stock-Based Comp Expense	$7.3	$4.6	$8.0	$7.9

The lower stock-based compensation expense added about 9 cps to EPS growth in the period. This is a phenomenon we expect to see a lot in the next couple of quarters due to the sharp price declines in most companies' share prices. To help in understanding the mechanics behind the sharp decline in stock-based compensation we present a quick review of stock option accounting.

When a company issues stock options to employees, it estimates the intrinsic value of the option at the time of grant. Calculating the intrinsic value is usually done utilizing the Black-Scholes option pricing model which requires many complex estimates including the volatility of the stock price over the contract period as well as estimates for the rate of forfeiture and exercise of options. The intrinsic value is then capitalized and amortized over the expected time over which the options are expected to be outstanding. Changes to these assumptions can significantly impact the periodic options expense. For a simplified example, let's say a company issues stock options in Year 1 with an estimated intrinsic value of $300 which is to be amortized over 3 years. The original assumptions include the expectation that 80% of options will be exercised over that time period. Over the first two years, actual experience matches the original expectations and there are no changes to the original intrinsic value estimate. The company recognizes $100 of stock option expense each year. However, at the end of year 2, there is an unexpected decline in the company's stock price, driving many of the unexercised options out of the money. The company

now estimates only 60% of the options will be exercised over three years, reducing the intrinsic value of the original options grant to $225. Since $200 million has already been expensed, there is only $25 million of unamortized option expense left to be recognized in Year 3 resulting in a sharp drop in stock-based compensation expense.

While SNA does not give any detail about the decline in stock compensation expense, the evidence indicates that something similar to the above example is at play. SNA discloses the amount of unamortized stock-based compensation for the various compensation types (stock options, performance share units, and stock appreciation rights) at the end of each quarter as well as the expected average amortization period. This is disclosed in the following table for the last three quarters:

	3/28/2020	12/28/2019	9/28/2019
Unamortized Stock Option Expense	$22.6	$15.6	$19.4
Average period (in years)	2.2	1.4	1.7
Implied Quarterly Expense	$2.6	$2.8	$2.9
Unamortized PSUs	$10.2	$7.3	$12.0
Average period (in years)	2.2	1.6	1.8
Implied Quarterly Expense	$1.2	$1.1	$1.7
Unamortized SARs	$4.0	$0.0	$3.2
Average period (in years)	2.2	1.5	1.7
Implied Quarterly Expense	$0.5	$0.0	$0.5

We see at the end of the 12/19 quarter that the implied quarterly amortization for the three major stock-based compensation expense components based on then-current expectations totaled $3.9 million ($2.8M +$1.1 M). However, stock compensation expense was only $1.1 million in the 3/19 period which was almost certainly due to the stock price decline reducing the estimate for stock option exercises on previous grants which lowered their estimated intrinsic values. However, at the end of the 3/19 quarter, the expected quarterly amortization was back up to $4.3 million as expectations for awards granted in the first quarter would incorporate current stock prices.

We should point out that while this dynamic worked in the company's favor this quarter, it is likely to work against it in a few quarters if the stock price recovers significantly and forces an increase in the estimate of the percentage of options that will ultimately be exercised.

Removal of Anti-Dilutive Shares Adds Another Artificial Boost

We discussed above how SNA's sharp stock price decline in the first quarter led to lower stock compensation expense. Another related side effect to lower stock prices is an increase in the number of option-related shares that are qualified as anti-dilutive. When a company calculates its diluted share base every period, it adds the number of dilutive securities to the outstanding share base. This includes potentially exercisable options under share-based compensation plans. However, if a security is anti-dilutive (its exercise would increase EPS), it is excluded from the diluted share count. Out of the money options under share-based compensation plans are anti-dilutive and therefore excluded from the diluted share count. The following table shows the components of the diluted share count for the last five quarters:

	3/28/2020	12/28/2019	9/28/2019	6/29/2019	3/30/2019
Weighted Average Diluted Shares	55,048,368	55,400,000	55,656,942	56,040,484	56,305,157
Antidilutive Shares Excluded	2,304,236	1,215,695	1,223,983	1,223,467	1,233,467
W/Average Shares Adj. for Antidilution	57,352,604	56,615,695	56,880,925	57,263,951	57,538,624
Growth in Reported WA Shares	-2.2%	-2.1%	-2.9%	-2.3%	
	-0.3%	-1.2%	-2.0%	-2.3%	
Non-GAAP Net Income	$143,200,000				
Reported Non-GAAP EPS	$2.60				
Non-GAAP EPS Adjusted for Antidilution	$2.50				

We see that there was a large spike in antidilutive shares in the 3/20 quarter as a result of the company's stock price decline. If we add the excluded shares back to the diluted share count, we see that rather than a 2.2% decline in diluted shares, the 3/20 quarter saw only a 0.3% decline. The exclusion of the additional shares resulted in a 10 cps increase in reported diluted EPS. Like the stock option expense above, this could reverse in upcoming quarters if a stock price recovery results in the shares related to these options being added back to the weighted average share base.

EPR Properties (EPR) EQ Update

Current EQ Rating*	Previous EQ Rating
4+	4-

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

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

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

We upgrade our earning quality rating to 4+ (Acceptable) from 4- (Acceptable)

The company's disclosure earlier this week agreed with our conclusion that EPR has very low operating costs and the current liquidity would carry the company for basically two years without much if any rent coming in from tenants. That includes paying the monthly dividend of 38.25 cents – which they announced on April 15 – well into the shutdown. The dividend is a 20% yield on the current $23 price.

The biggest risk we saw was the leverage at AMC causing it to restructure its balance sheet. AMC is 17% of EPR's total revenue. AMC's capital spending was already scheduled to decline this year, helping its free cash flow situation. Its rent expense is $80 million/month and interest expense is $130 million every six months. **AMC is raising another $500 million in April, which should allow it to survive for the shutdown.** It may still need a longer term solution later depending on how business bounces back. **EPR went more conservative on its revenue recognition from AMC by only recognizing revenue that arrives in cash.**

We noted that EPR had two years of revenue in cash on its balance sheet - $1.25 billion. That would enable it to pay its own lease expense ($26 million per year), interest expense ($142 million per year), preferred dividends ($24 million per year), and it only has 66 full-time employees. If the company isn't paid a nickel in rent for several months – it could still pay its bills and the dividend. EPR put out a time-line for cash burn of $51 million per month based on paying the dividend and other expenses while only receiving various percentages of rent against its cash.

EPR Months of Liquidity at %'s of Rent Paid	0%	15%	25%	50%	100%
$23mm monthly burn without Dividend	43	65	99	no limit	no limit
$51mm monthly burn with Dividend	19	23	26	40	no limit

The amount of leverage at EPR's customers remains a risk in our view. The worst situation is AMC. However, as the economy opens, we believe it will start generating revenue again and doesn't require people to book a flight and hotel to see a movie. Falling capital spending will help AMC's free cash flow and it can start to retire debt too. The latest infusion of liquidity for AMC makes it highly likely that it survives as structured through the Covid-19 issues and will be able to make rent payments to EPR.

TransDigm Group (TDG) EQ Update

Current EQ Rating*	Previous EQ Rating
3-	3-

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

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

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

We are maintaining our earning quality rating at 3- (Minor Concern)

The primary reason for this note is to remind readers of how much debt TDG is carrying. It recently paid a $1.9 billion special dividend, which cut cash to $2.3 billion against $18.0 billion in debt. The net debt/EBITDA ratio would be 5.6x based on 2020's forecasts of $2.8 billion in EBITDA. That forecast is no longer valid.

The company gets half its sales from commercial aircraft orders for OEM and aftermarket business. As more planes are grounded with a lack of travel demand, there is less maintenance needed and the Boeing has reduced production too. TDG has cut shipments, laid off 15% of its workers, and plans to have 1-2 week furloughs at various plants for the next six months. It is paying workers severance plus $4,000. Reduced sales and cash payments will both work to reduce EBITDA. Growth has come heavily from acquisitions and efforts to buy other companies may be reduced this year too to conserve cash.

Liquidity is not the current issue. TDG has issued $1.5 billion in new notes this month and that should be adding to cash – while keeping the debt ratio flat if they don't spend the cash. Longer-term, TDG is still the same company with a largely captive customer base building and maintaining long-lived expensive assets (although we question several items in the accounting regarding acquisitions and whether the company may have trouble boosting prices as discussed in the December 2019 report). **However, in 2020, the issue may be the debt ratio. If they spend some of the cash, they raised, it boosts the net debt figure. At the same time, EBITDA is falling.** Here's what happens to the debt ratio:

Net Debt

TDG Net Debt ratios	$15.7	$16.0	$16.2	$16.4
EBITDA				
$2,800	5.6	5.7	5.8	5.9
$2,600	6.0	6.2	6.2	6.3
$2,400	6.5	6.7	6.8	6.8
$2,200	7.1	7.3	7.4	7.5

- **The first issue is the maximum net debt ratio for TDG is 7.25x.** That becomes an issue if EBITDA drops 20% below the original forecast.
- **The second issue is when debt exceeds 5.0x EBITDA – TDG has to prepay its $7.5 billion in term loans using 50% of excess cash flow.**
- The third issue is EBITDA isn't the cash flow – there is still over $900 million in interest expense, $100 million in capital spending, and $150-$250 million in taxes to pay.
- **For 2020, free cash flow may be in the range of $800 million to $1 billion.** Half of that would likely need to repay bank debt.
- For 2019, TDG declared $1.7 billion in dividends in August 2019 and $1.9 billion or January 2020. Investors may see a dramatic drop in future dividends and the company's growth rate may drop if it cuts back on acquisitions and organic growth is negative for as much as 6-months.

McCormick (MKC) EQ Update 2/20 Qtr.

Current EQ Rating*	Previous EQ Rating

3+	3+

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

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

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

We are maintaining our earnings quality rating of 3+ (Minor Concern)

MKC beat the consensus estimate in the 2/20 quarter by 5 cps. The company's reporting cycle caused the February quarter to be negatively impacted by COVID-19's effect on the Chinese market but miss the full effect of pantry-stocking later enjoyed by the European and US markets. Management noted in the call that since the end of the quarter it is, not surprisingly, seeing a significant uptick in demand from both the stay-at-home market as well as for flavor solutions from its packaged food company customers. For now, this should be more than ample to offset the 20% of the business which supplies restaurants and is currently under pressure.

- Inventory DSIs jumped by more than 7 days over the year-ago quarter. The slowdown in China as well as inventory destocking by retailers in the US (before pantry stocking kicked in) likely contributed. Management also indicated that it was building inventory as a cushion to cover for disruptions from its ERP project which has since been suspended. Under ordinary circumstances, such a jump in DSI would be a concern, but with stores now struggling to keep their shelves full, we are certain any excess inventory has already found a home. The pantry stocking phenomenon will give many companies that carried excess inventory into 2020 (such as CAG) a clean slate on that part of the balance sheet moving forward. When asked about the inventory situation on the call, management replied "..if we had not been as well prepared as we were on the supply chain side and also, frankly, building some inventory in preparation for our ERP shift that - which might echoes down all the way through our supply chain, we would really - we'd be even more stressed than we are right now."

- A remaining area of concern is the company's rapid increase in payables. Payable days increased to almost 97 days, a 17-day jump over the year-ago quarter. MKC's days payable have risen from the mid-60 range to almost 100 over the last two years providing a huge boost to cash flow. We are certainly not against minimizing working capital, but the level of payables growth and the resulting cash flow tailwind cannot continue indefinitely and will likely reverse at some point. This is the primary factor keeping us from upgrading MKC to a 4 (Acceptable) rating.

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

Rating	Description
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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