BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Altria 1Q20 Update
Maintain SELL

We maintain our SELL rating on MO. The company continues to get 88% of revenue and 87% of operating income from selling cigarettes. It is still reporting market share losses as it raises prices and saw its adjusted volume fall 5% in 1Q20 against 7% drops in both 1Q19 and 1Q18. All of those declines are 150-200bp worse than the market overall. MO said it believes some older smokers may have switched to e-cigarettes but have now returned to regular cigarettes following negative publicity. **So, if -5% growth and coming in 150bp below the market is a recovery, there are still bigger problems here. It also believes distributors may lower their inventory levels which could hurt sales further throughout 2020.**

We have discussed this long term decay as a problem for MO and its history of diversifying into new areas has been mixed to say the least with write-downs, restatements, and carrying values exceeding fair market values. We won't discuss this decay issue too much more in this note other than to point out Altria has lost 18% of its volume since 2017 after -7%, -7%, and -5% growth. MO admits that this year its dividend should exceed its EPS target of 80%. **They also not only stopped share repurchases in 1Q, they canceled the remaining authorization for $500 million in repurchases on the July 2019 plan.** Share repurchases had already been declining significantly in recent years and MO simply has not had the cash flow to support both the dividend and repurchase program in our view. **It used to borrow money cover both but has now squandered a huge amount of borrowed money to invest in JUUL and Cronos with no cash flow coming in from those areas.**

Also, of note, the lawsuits for JUUL are beginning. After 1Q19, only 2 were outstanding. After 4Q19, there were 101. Now there are 202 lawsuits which include 24 class actions, 5 state/local governments, and 3 school districts. Those may require more cash costs going forward. We believe investors should still be concerned with:

- There is still no ABI Impairment and MO may actually continue boosting its carrying value amid the latest dividend cut and stock decline. ABI's stock could double and still be underwater.

- ABI's situation has worsened as it is debt/EBITDA ratios are likely rising. The lock-up on its ABI shares expires in 17 months for MO and the auditors have already highlighted an impairment in this area as a risk.

- The Cronos investment has also not seen an impairment even though its carrying value exceeds fair market value too. The company has restated revenues in 2019, it operating losses are growing and there's no cash flow. The stock now trades below levels before MO's announced purchase.

- The Wine business has seen impairments. This is interesting given that it is privately held whereas the ABI and Cronos have an easy check with market prices on the stock. Wine has had impairments and write-downs in three straight years.

- Graphic Packaging is likely to start in June 2021. This has been proven to be effective in causing people to smoke less frequently or quit altogether. The FDA has not exempted packages for heat sticks for the IQOS system MO is rolling out.

- Lawsuits by Reynolds and other tobacco companies may have a tougher hurdle to stop graphic packaging this time. In 2012, the courts overturned the specific photos being used – not the law requiring the FDA to mandate graphic packaging. The new graphics incorporate large text warnings that are research-driven about smoking health issues – and text warnings have been in place for decades now. Also, the pictures are tamer in appearance.

- Menthol issues have not disappeared either. The FDA has been heavily focused on youth smoking and e-cigarettes – boosting the age to purchase either to 21 and banning all flavors other than menthol. It continues to study a menthol ban in relation to helping people quit. Massachusetts has banned it, many cities and counties in California have banned it, the House passed a ban recently, and UK's ban takes effect on May 20.

Equity-Method Accounting is Pushing up MO's Carrying Value for ABI

MO essentially adds its pro-rata share of ABI's net income to its carrying value and any dividends received reduces the carrying value. When the dividend was 3.6 Euros per year, it was close to income and it was nearly a wash. As the stock fell when the dividend was cut to 1.8 Euros, MO not only didn't book an impairment – it saw the carrying value of its investment rise. Now that ABI cut the dividend again to 1.3 Euros, this situation could continue to boost the carrying value for an investment that is underwater based on market values:

ABI value	1Q20	2019	2018
Carrying value	$18.5	$18.1	$17.7
Fair value	$8.8	$16.1	$13.1

Most of the ABI shares owned by MO are restricted until October 2021. They will convert into ordinary shares 1:1. The carrying value has exceeded fair market value for years. ABI has been forced to focus its efforts on retiring debt with free cash flow for some time. With the virus, it has issued more debt to add to its liquidity and cut the dividend again. ABI is selling its Carlton operations in Australia and expects to close in the 2Q. With those proceeds that have not arrived yet, ABI's debt to EBITDA would have been 4.0x based on 2019 EBITDA. Since then, the virus is impairing

EBITDA and ABI is borrowing more money. There are not many signs pointing to ABI restoring its dividend in the near future. If the value of that stock doubled, MO's investment would still be underwater.

Cronos Stock Has Continued to Fall

We noted last quarter that MO's Cronos investment was worth $1.2 billion against the carrying value of $1.0 billion. Its stock has continued to fall making MO's investment worth $0.9 billion and below the $1.0 billion carrying value in March 2020. Cronos restated results for quarters 1-3 in 2019 as well that reduced revenue by $2.5 million in 1Q and $5.1 million in 3Q. This is for a company with quarterly revenue not much higher than that before the restatements.

We have noted that the only source of profits at Cronos came from having its stock price collapse and the value of its derivatives related to MO's warrant to buy another 10% of its stock rise as the stock fell. Interesting to note that Cronos makes this statement in its financial statements, *"Share price is one of the significant observable inputs used in the fair value measurement of each of the Company's derivative instruments."* While MO doesn't change its carrying values of assets based on falling stock prices – Cronos does. It took a $1.3 billion gain in 2019 based on the derivative liabilities being revalued with its falling stock price. Its operating income was -$121 million and operating cash flow -$130 million.

With this stock below levels than before MO's first announcement of its investment, we would expect this investment could see impairments in the future.

MO Has Taken Many Write-downs for the Wine Business

JUUL is a private company and MO took several write-downs there in 2019. It even started accounting for JUUL on a cost less impairment method meaning it will not raise or lower the value on earnings/losses – only if it observes any price changes in orderly transactions of in the same class of shares in JUUL. Even with Covid-19, there were no further impairments. (There likely were not any "orderly" transactions even if private trades did occur.)

What is curious is another non-public entity – its wine unit - has seen many write-downs and impairments in recent years.

- 2018 saw wine operating income fall $96 million, fueled by a $54 million impairment of Columbia Crest's trademark.
- 2019 saw wine operating income fall another $53 million, driven by a $74 million impairment of goodwill.
- 1Q20 saw wine operating income fall $394 million y/y, caused by $292 million inventory write-off and a $100 million in losses on future non-cancellable grape purchase contracts.

Graphic Packaging is Coming in by June 2021

The FDA released its final rules for new warnings on cigarette packages. These will require a series of new warning labels that will include new text and color graphics. Warnings will include new text warnings such as "smoking can cause bladder cancer" or "smoking can cause strokes by clogging arteries." It will then have a color picture that in some way illustrates this to match the text topic. These warnings will cover the top 50% of space on the front and back of a package of cigarettes.

In early April, several of the tobacco companies (Altria was not included at that time) filed a lawsuit against the FDA challenging the new rules and mandates on warnings.

There are several reasons to believe the tobacco companies will fail in the attempt to stop the graphic packaging:

- The Family Smoking Prevention and Tobacco Control Act was passed into law in 2009. That law requires the FDA to mandate cigarette warnings be accompanied by graphic pictures showing the negative health effects of smoking.
- The FDA's first shot at this essentially showed photos of people with tracheotomies smoking or people missing many teeth and the others being very gray. The tobacco companies filed suit against this type of packaging. A court overturned the specific images – but did not invalidate the mandate that the FDA require graphics.
- It was the federal courts again who reprimanded the FDA in 2017 and said they still have a mandate to implement graphic packaging and required a plan be in place within two-years.

- The FDA's new attempt at meeting this mandate is to have research-driven findings made into health warnings that are part of the graphic, with pictures. The new text is generally about half the space used for the total text and picture.
- The focus is also that, many of the current text on the side of cigarette packages have been in place for so long that few people read them anymore. However, the text warnings having been in place for decades are widely accepted. So updated text as key parts of the graphic mandate should make it easier to clear legal challenges.

Our view is the original case denying graphic packaging was narrowly focused on the content of those photos – not that graphic packaging mandates should be overturned. It was more like banning profanity on the radio was not overturning all free speech. With new graphics that rely more heavily on text educating people on additional health impacts of smoking along with PG-rated pictures instead of NC-17 level – these seem more likely to be upheld. Graphic packaging is also already in place in 125 other countries.

The problem for Altria and other cigarette companies is graphic packaging has been shown many times to cause more people to stop smoking. It also leads more people to avoid starting in the first place. A big part of this is cigarettes are one of the few types of packaging that people carry around and look at many times per day. That's not true of a hamburger wrapper or a beer can. Also, non-smokers will see the new cigarette packaging much more often if they are around smokers. Studies point to people smoking less overall after seeing the graphic warnings more often, more people focusing on quitting, and more people no longer smoking around children.

It is also worth mentioning that the FDA has not exempted Heat Sticks for the new IQOS heated tobacco the MO is currently rolling out from graphic packaging.

Menthol Issues Continue

We have talked about a potential menthol ban many times in reports on MO. The FDA continues to study whether to ban menthol in cigarettes. Most studies show that menthol is not addictive; however, it makes it easier to take up smoking and smoke more. Other studies show that 80% of young smokers start via flavored tobacco including menthol.

The FDA has been much more focused on stopping youth vaping and preventing nicotine addiction in that manner during late 2018 and 2019. It has banned flavors for cigarettes and e-cigarettes other than menthol. At the same time, it still sees e-cigarettes as a way to get smokers to stop using combustible cigarettes. Therefore, it does not want to create a situation where menthol cigarette smokers do not have a non-smoking menthol option – thus keeping menthol e-cigarettes available. It continues to study how best to deal with this issue and whether to ban menthol altogether, in stages, or not at all. Push back comes from civil-rights leaders also who note that more minorities smoke menthol cigarettes. While other civil-rights leaders argue, that's especially why menthol should be banned – minorities have higher smoking rates and problem rates as a result.

While that hot potato issue continues, the state of Massachusetts has banned menthol cigarettes. Also, numerous towns and counties in California have also banned them. The UK's ban begins on May 20, 2020. Canada has had a ban in place for a couple of years and studies are showing that more people have quit smoking after the ban.

Vaping among teens has taken most of the recent focus. But we do think menthol bans will be an issue that does not go away for Altria. More importantly, the national ban on selling any tobacco product including e-cigarettes to people under age 21, went into effect in December. At some point, the FDA may be able to reframe this debate around banning menthol in cigarettes pushes people to menthol e-cigarettes; with less worry that menthol e-cigarettes become the gateway for young people to start smoking menthol cigarettes. But it's only been 4-months of change at this time.

Starwood Property Trust (STWD) 1Q20 Update Maintain BUY

We are **maintaining our BUY recommendation on STWD** after 1Q20 results. Several positives and safety features were evident in the results and STWD sped up its earnings release to report strong results and outlook. Core EPS of 55-cents was higher than each quarter of 2019. As we noted in our original report, we think Dr. Malkiel would have a difficult time justifying that STWD is an efficiently traded stock. The reason STWD remains a hidden gem despite many positives is it trades in Mortgage REIT ETFs. When people are scared about NLY or AGNC – they sell the ETFs that also own STWD, which gets hit regardless of its positives. In discussing whether to buy back its own stock at lower levels this quarter, Barry Sternlicht noted this week, *"It seems like not the smartest thing to buy back stock and to hopefully wait for the stock to recover to levels on its own. We can't fight these ETFs, and it's simply just a waste of energy and capital."*

STWD has the liquidity and desire to pay its dividend as it paid 1Q's dividend in April. Keep in mind that many of the greatest deals this group has done, happened in periods of extreme market dislocation. As a result, the company added that it is keeping its flexibility available at the moment and noted:

> "*So I think we're feeling the book (value) is very safe. And I should talk for a second about the dividends. Our dividend policy will follow the philosophy of safety for the company.* ***Can we earn our dividend? Yes. Should we pay it out?*** *We're going to decide as the future unfolds.* ***So, we will wait till June to see how the year looks.*** *What's happened to the return of the economy? How our borrowers are fairing?... Signs are good, and we sent all this cash. So, we're going to do the prudent thing, and make sure that* ***obviously as a major shareholder, myself, I would like us to pay the maximum dividend we can, but we are here for the long run*** *and that will be a Board decision."*

In a show of support that it does think the stock is cheap, the company reported its manager group will take its base management fees of $19 million in stock. We believe the book value is understated here and STWD has a very conservative approach to investing and long-term value should be unlocked:

- **The commercial market for STWD's loan book simply is not in tatters. The biggest fear in March and April was whether office buildings would make their mortgage payments. STWD received all interest and payments due from over 99% of all borrowers in April.**
    - STWD's Loan to Value is only 61%
    - That is a safety feature by itself as the company notes this isn't 2008 where borrowers owed more than the property was worth, if you have 40% equity, you're going to pay the mortgage.
    - STWD also evaluates who its borrower's tenants are. The biggest source of weakness in office buildings it sees are shared space – where many 1-3 man shops occupy several floors.
    - Hotels have some problems, but the bulk of STWD's loan book is paying the mortgage notes.

- **Its property segment continues to outperform all expectations. 95% of the rent was paid in April here too. They have chosen unique properties carefully:**
    - The apartments in Florida have the rent tied to income levels and growth in the area. They expected 1%-2% growth in rents. Instead, they just received a 5% rent increase on top of 4% hikes in the prior years.
    - Once the rent increases, it cannot fall in these properties. Thus, the cash flow stream is rising.
    - At the same time, the cost of financing these properties is declining as STWD as refinanced them multiple times. The cash on cash yield is 14.6% now.
    - They are currently refinancing one of these properties again – it will increase cash liquidity for STWD by $85 million and lower borrowing costs by 100bp. So, the cash on cash return is going up again.
    - Occupancy at 97% and rising cash flows should indicate that the value of this property is increasing. Yet, depreciation has reduced STWD's book value by $1.18 per share. This is a great undervalued asset on their balance sheet in our opinion.

- **LNR – the mortgage servicing unit is beginning its ramp-up. This unit deals with troubled mortgage loans and earns fees to amend terms, refinance debt, repossesses property and/or resell it. It is a great source of income that comes in during troubled times**

  - STWD bought this after the 2008-09 issues as its business was slowing – that was by design as it was cheap.
  - STWD noted that the business has accelerated for LNR, "*Our special servicer has not been busier in the seven plus years we have owned LNR. We have onboarded over 500 loans since COVID-19 representing over $14 billion in assets.*"
  - "We shifted a bunch of assets (staff) over to that side (LNR) because the servicers now overwhelmed with requests for forbearance, particularly in the hotel space."
  - This source of income may start to appear in 2Q20 but will build throughout the year and 2021. The bigger fees come from restructuring loans and working with the asset beyond granting a short-term interest deferral.
  - Barry Sternlicht summed it up well, "*So it's early in the lifecycle. The servicer company once made hundreds of millions of dollars. While it's been exciting, it probably would mean that we've faced more issues on some of our hotels on the other side of the house. So, we're happy here where we are, and it's nice to see that revenue stream increase, but don't think of it as a massive windfall yet. It's just a hedge against everything else we do.*"

- **Interest Rate Floors are helping protect income as the rates decline. We have been noting that STWD's EPS is set up to increase even as rates fall because of this.**
  - Over 90% of the loans on the books have LIBOR floors now.
  - STWD estimates it has $90 million in gains on these floors and another $50 million in gains in FX hedges on International loans.

- **All the work on the financing side of the balance sheet is paying off now as it is preserving liquidity with $870 million available – normally they operate with much lower levels of cash as that is a drag on their results, but right now it's an asset.**
  - We talked in past notes that STWD had always diversified its financing and spent much of 2019 boosting that process with the sale of A-notes, securitizations, and even CLOs.
  - The net result is it has longer-term maturities and unencumbered assets (which can be used to boost collateral on other financings or sold to generate more liquidity) on the balance sheet. When credit spreads

widen and asset values decrease, they are not facing calls on their short-term borrowing to put up more capital.

  - Their size and credit rating offsets some of the incrementally higher rates paid to have fixed-rate debt on longer terms. But enhanced liquidity has value too.
  - They continue to focus at this time on A-notes over warehouse lines. Basically, STWD wants to lock in the asset and funding for a longer time on any deals they look at in the current market.
  - Their hotel loans are a case in point. STWD is working with $1.5 billion in hotel-related loans on $1.0 billion in warehouse loans. Its liquidity situation allowed it to prepay the warehouse lines and get bank agreement on 94% of the loans in question to allow it to modify loans where needed over the next 6-9 months without having margin calls.
  - STWD has hotels with LTVs in the 60s, many newly renovated, and part of the larger flagship companies. It has the ability to grant items like using maintenance fees for debt servicing, closing hotels entirely to save operating costs, and defer rent for a period of time. It also allows time to restart the hotels and modify further as they see how the rest of 2020 plays out. STWD is not forgiving interest but is extending loan terms. It has already made its payments on the warehouse lines and is in a position to allow the hotels to reopen and resume payments without dealing with margin calls.
  - This emphasis on the right side of the balance sheet is why STWD also made a comment on the call that while it doesn't want to fight the ETFs that hold its stock – buying back some of its own debt where it finds it is trading too cheaply may be an area it examines more than repurchasing stock.

- **Mark-to-Market hits under the new accounting rules requiring loss reserves to be based on third party modeling data over the life of loan demonstrates STWD's conservatism**
  - Adoption of these rules actually lowered the LTV ratio beyond what STWD was estimating in January. STWD was frequently about 64%-65% and in the new CECL rules said it was 59%. CECL now sets the LTV at 61%.
  - One of the loans that STWD internally rated very low in 4Q19 was repaid at par and reversed a $3 million loss reserve in 1Q20.

    - Two grocery distribution centers have been leased to a new tenant in 1Q also on a long-term deal that could produce a $50 million positive swing in reversing loss reserves and booking gains.
    - Setting up the new CECL loss reserve in January did not impact earnings but was charged against book value for $32 million. In March, reserves were boosted again by $49 million for CECL – 17-cents in EPS.
    - Mark-to-Market losses were another 58-cents in EPS in the 1Q20 and were driven by credit spreads widening. As we noted in the ARCC update, credit spreads have already declined about 300bp and with STWD reporting assets at fair value – it could see some of the mark-to-market declines recover.
    - These MTM hits do not have cash impacts unless the security is sold at the time. STWD has not had any forced sales and expects to hold many of these assets long term.
    - The positive liquidity situation also reduces the risk that any of these assets need to move in a fire-sale.

- **STWD plans to go on offense and buy more assets at higher yields**
    - LNR may end up bringing some deals to it.
    - They have no intention of selling equity at 70% of book value to finance anything. STWD plans to lock up financing with A-notes or some other type of longer-term instrument.
    - In some cases, volume has been hard to find, but STWD noted a few times on the call it is buying loans that it believes are being mispriced due to market stress.

Jeff DiModica, the President summed up the situation at STWD well:

> ***<u>"We are confident enough in our excess liquidity position that we have in fact recently gone on the offensive and begun investing capital selectively at extremely attractive level.</u>*** *We moved our earnings call up three days this week to provide more information to the market earlier and heard that people think we did so to allow us to come to market quickly to raise capital. That is not our plan.* ***<u>We have no need or plans given our excess liquidity to raise debt or equity capital in the near future, absent an unforeseen opportunity."</u>***

LyondellBasell Industries (LYB) 1Q20 Update
Maintain BUY

We are maintaining our BUY recommendation on LYB. The company is confirming its $350 million quarterly dividend as a key part of its return of capital to shareholders, which has a yield of 7.6% on a $55 stock price. The liquidity was strong to begin with but has been recently enhanced – There was $1.8 billion in cash and securities at the end of March and short-term debt of $1.5 billion plus $0.5 billion on the credit revolver. In April, LYB issued $2.0 billion in medium-long term notes and repaid the revolver and $0.5 billion on the US receivable facility. That would leave $2.8 billion in cash on hand against $1.0 billion in other short-term debt (mostly commercial paper of $0.8 billion) and no maturities of long-term debt. Plus, the entire $2.5 billion revolver is untapped.

- **LYB had over $5 billion in liquidity at the end of April.** LYB also expects to see cash flow enhanced going forward by declining working capital adding $500 million. That should fall with lower prices and LYB is cutting DSIs too. LYB also plans a reduction in expected capital spending of $500 million from $2.4 billion. There are also no debt maturities in 2020.

- **LYB still produced $1.1 billion in EBITDA for the quarter. EBITDA generally runs between $1.5-$2.0 billion per quarter, so 1Q20 had some additional negatives hit with the economic slowdown along with some maintenance. However, much of what was hit is focused on fuel sales and that should return more quickly.** The company is pointing out that about half its business goes to consumer packaging and medical. Autos and durable products are 20%-25%. The remaining 25%-30% is fuel related.

- **2020 EBITDA may cover 2020 cash needs without tapping liquidity.** Assuming a 2Q and 3Q that produce only $1.8 billion in total EBITDA for two quarters and 4Q that comes in another weak at $1.1 billion – LYB would have $4.0 billion in EBITDA – against taxes, interest, pension funding of $800 million, capital spending of $1.9 billion, and the dividend at $1.4 billion. The $5 billion in liquidity and declines in working capital appear to be more than enough cushion.

- **LYB saw strong growth in large areas of its business that is likely to continue.** Hardest hit were items related to car production and fuel. Medical-related business, take-out food containers, frozen food packaging, home-delivery packaging all saw strong growth.
    - ***"lifestyle changes are creating a new normal as consumer-based demand for frozen, dairy, and packaged food has risen by approximately 30%.*** *Surveys indicate that after staying at home during the pandemic, 40% of Americans plan to increase the amount of time they work from home and 65% intend to eat at home, more often*." – CEO Bob Patel.
    - Consumer demand surged with pantry stocking for food, medicines, household items, and items shipped directly to the consumer. All of that is part of LYB's end markets. We should add this includes frozen food, fresh food wrapped in plastic or plastic bags, food bought on-line, soap… It's now just restaurant take-out trays.
    - Margins stayed strong too, *"Consumer-driven demand for polyolefins used in packaging and health care products, **supported relatively stable integrated polyethylene margins**, in the Olefins and Polyolefins - Americas segment. **Lower feedstock prices resulted in higher integrated polyethylene margins** for our O&P – Europe, Asia, and International segment.*
    - Even plastic bags are returning, "***Reversal of bag bans on the West Coast on the East Coast those could stay for a while. I think what people are realizing is that there are very significant hygienic benefits to plastics and that single-use has benefits."***
    - Lower oil prices and reduced driving hurt the refinery and oxyfuels – but that should recover. *"In oxyfuels, we should start to **see some benefits from the volume rising**. **Higher oil price also helps in terms of oxyfuel profitability.** So, both should directionally improve as the lockdowns are eased and as activity at least daily activity returns to more normal levels."*
    - That leaves durable goods like new cars, which will likely take longer to recover.

- **The dividend has been confirmed as well.** *"In terms of capital allocation, we're very consistent in our view that **the dividend is a high priority for us** coupled with a strong BBB or investment-grade rating, which today is BBB for us. So, I don't expect that we would undertake buybacks given that we're prioritizing* *liquidity.* ***Our dividend we expect that we will recommend the May dividend to our Board. We expect that they'll approve that dividend for Q2.***"

- **LYB talks a great deal about its ability to use multiple types of petroleum feedstocks – Oil-based naphtha or Natural Gas Liquids like ethane, butane, propane. We have pointed out for years that LYB has a cost edge over non-US chemical plants when Oil is priced above 8x Natural Gas. It currently is with Natural Gas at just under $2 and the low point for gas was $1.60.**

- **A lack of drilling is unlikely to disrupt this cost advantage in the near term either.** Ethane (an NGL) is still being produced in quantities greater than the market needs and it is simply being burned as natural gas in power plants. Plus, current wells continue to produce, and new gas pipelines are ramping up, bringing in more supply. Much of the NGLs are found with oil production so if slower drilling drives up NGL prices, it should also push up oil prices and keep the cost edge in LYB's favor.

- LYB has more maintenance scheduled for 2Q as well – taking capacity offline now should help other facilities operate at higher levels and help margins.

Ares Capital Corp. (ARCC) 1Q20 Update
Maintain BUY

We are **maintaining our BUY recommendation** on ARCC after 1Q20 results. Mark-to-Market unrealized losses were the biggest hit to results at $2.04 per share. Much of this was driven by the widening of credit spreads, which increased 730bp during March to 10.9% at the peak. The St. Louis FED tracks this statistic, which has already recovered back to back into a range of 7%-8%. We believe some of the $880 million in unrealized losses will be recovered back into equity before the end of the year.

During March, 99% of scheduled payments were received. ARCC had only 10-loans that were modified in March. April likely saw a larger number of modifications, but their remains a very small weighting in the portfolio of industries that have been hardest hit by all this: Energy is 2.3% of the portfolio, Retail is 2.3% - but the largest customer is a convenience store chain, and the rest is largely distribution related, Restaurants 1.8% - the largest operates in airports (OTG $194mm); Hotels 1.2% the largest is a banquet planning operater (Cipriani $115mm); and Health Clubs 0.2%. Their retail looks OK. Energy has been marked down already as has OTG. These problem areas are only 5.5% of the portfolio now. It is worth noting that the underlying growth rate for the companies in ARCC's portfolio was at 5% before the shutdowns – up from 3% in 4Q19.

ARCC has seen the Debt/Equity ratio rise to 1.26x at the end of 1Q20. That is largely due to Equity declining by $884 million ($612 million loss - fueled by the $880 million unrealized loss from mark-to-market, + $100 million in stock repurchases + $172 million in dividends paid). It would have been 1.11x without the $880 million unrealized loss.

ARCC retains significant liquidity of $2.6 billion to work with existing companies and make new investments. It also has a small backlog at the moment of new deals to fund with potentially more cash coming from loan participations sold to Ivy Hill or repayments. There are many signs pointing to this getting better quickly for ARCC and the stock:

- **Falling LIBOR is unlikely to have a material impact on results going forward**

- 85% of the portfolio is floating rate while only 44% of the debt is.
- LIBOR declining has been costing ARCC about 1-2 cents in EPS in recent quarters.
- We estimate the decline in 1Q20 was 3-cents in EPS.
- Positive – 79% of the floating rate portfolio has LIBOR floors in place at an average of 1.1%. Those are in the money at this point.
- If rates stay extremely low, ARCC will see a smaller impact from that going forward.
- If rates rise, ARCC should see yields increase and help EPS at this point. A 100bp rise in rates adds 6-cents to quarterly EPS and 200bp adds 11-cents.

- **New Loans and New Modifications Should Add to Income and Protections**
  - New loan activity is low – but April investments priced at a 14.7% yield.
  - Many of the loans ARCC works with also have Private Equity backers (83% of the loans) and they are working both the companies and Private Equity investors to ensure liquidity is available for ARCC investments. Many of these are long-standing relationships.
  - ARCC is willing to make concessions in some cases to help ensure survivability of the underlying company.
  - Positive – when modifications do occur – ARCC is often getting more equity put into the situation or some equity participation for itself, tighter loan documents, and re-pricing risk – thus higher yields.
  - As noted above, we only see about 5.5% of the portfolio in problem areas and the underlying businesses have been posting 4%-5% EBITDA growth for several years at this point.
  - We think this along with credit spreads tightening should also help the equity base recover some of the mark-to-market unrealized losses in 1Q20.

- **Liquidity Is Strong at $2.6 billion for ARCC to Cover All Commitments**
  - ARCC does not expect a surge of companies drawing down revolvers from ARCC at this point, but the total remaining commitment there is $1.0 billion. ARCC also has a $210 million backlog of deals to fund.
  - In addition to the current $2.6 billion in liquidity, deals that are sold to Ivy Hill and maturities will add to liquidity. Also, 75% of assets are supported by unsecured debt and could be mortgaged/sold for additional liquidity.

- If ARCC opted to simply walk on 100% of its $335 million in energy investments, the remaining problem areas of hotels and restaurants only have $435 million at risk and could require some new capital.
- There will be other issues in the portfolio too, but many may be resolved with smaller amounts of rescue financing. Plus, the private equity players have a stronger incentive to pay for the rescue – they are lower in the capital structure on the deal.
- Negative – expect bigger non-accruals from energy in our view in 2Q but this looks manageable.
- Positive – ARCC declared it sees no reason to issue additional equity.

- **ARCC Committed to the Dividend**
  - The spill-over income of $0.96 per share representing past income that has not been distributed yet and helps support the dividend at this time when GAAP EPS was -$1.42 after the $2.04 hit from mark-to-market on unrealized losses.
  - ARCC held the dividend at $0.40 and announced they were confident in holding the steady dividend level for the foreseeable future.
  - At $13 per share, the yield is 12.3%.

- **Share Repurchases Should Boost Provide Solid ROI**
  - The company already spent $100 million repurchasing stock under $12 for a 13% ROI on the deal.
  - ARCC still has $393 million available on repurchase authorization and being comfortable with its liquidity will continue to look at repurchasing shares as a high ROI proposition for cash.
  - Buying back shares below book value of $15.58 is also accretive.
  - We think ARCC will balance share repurchases with seeing some of the mark-to-market valuations recover as buying shares reduces equity and pushes up the Debt-to-Equity ratio.

In our view, ARCC has several tailwinds that should be working in its favor as the worst of the shutdown definitely impacted 2Q20 results but is now past us as business reopens.

- Interest income is likely to be rising going forward with the LIBOR floors in the money

- Fair Market Values should increase with lower risk premium spreads and boost equity
- The bulk of the portfolio is not travel, restaurant, energy-related and was growing at an accelerating rate before this
- The company is in a position to enhance its yield and thus income through any loan modifications needed and any new financings put out in this market
- Non-accruals will likely peak during 2Q and decline thereafter. Non-accruals are 3.1% now and already reflect some sizeable reserves for energy and restaurants.

Citrix Systems (CTXS)

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 are maintaining our earnings quality rating on CTXS of 4- (Acceptable)

We saw no negative developments in the quarter, but the COVID-19 induced scramble by businesses to set up employees to work from home led to a spike in demand for CTXS's solutions. Some one-time moves made by the company to address the situation have temporarily distorted the trends we discussed in the original report.

- To review, in 2017 CTXS accelerated its push to a cloud-based subscription model and away from perpetual and term service agreements. This resulted in more revenue being paid and booked over time which has a negative impact on reported sales growth and cash flow growth. However, to help customers that were scrambling to get employees set up to work from home, CTXS introduced a limited use on-premises term license product. These contracts amounted to about $47 million of revenue in the quarter which was recognized upfront. The company plans to phase out this license program in April so these revenues will not repeat. The impact of these special licenses can be seen in the huge jump in non-SaaS revenues which were up over 160% in the quarter versus a recent run rate in the 40-50% range. Average contract term also fell to 1.3 days from 1.7 reflecting the short-term nature of these licenses. Also, the almost 14-day spike in receivable DSOs was likely a result of this phenomenon.

- Demand remained strong in the cloud-based subscription model as growth in subscription SaaS annualized recurring revenue jumped to 50% from 40% in the previous quarter indicating long-term commitments from customers. Much of this was likely existing term and perpetual customers migrating to subscription-based services. The boost to revenue, particularly the upfront recognition of the short-term term license deals, will likely not repeat to the degree seen in the 3/20 quarter. However, longer-term, the new recognition of the value of having a remote-enabled workforce will likely result in more demand for the company's solutions and much of the special term license business may eventually find its way back in the form of subscription deals, although such revenue will be recognized over time.

- We highlighted in our original review that despite more product revenue being deferred, overall deferred revenue has been declining since the bulk of the balance is from service contracts related to perpetual licenses which are declining. The decline in deferred revenue days decelerated to -5 from the -20 range seen in previous quarters as it appears the decline from term service license erosion is becoming offset to a higher degree by revenue deferred under new subscription service contracts.

- Lower stock-based compensation added about 4 cps to EPS in the quarter. Given the huge earnings beat, we are not assigning a high level of concern to this.

- CTXS boosted its allowance for bad debts to 2.6% of gross receivables in the 3/20 quarter from 1.3% in previous periods. We estimate this cost the company a little over 5 cps in the quarter.

- The company entered into an accelerated buyback in January to repurchase $1 billion in shares. In the first quarter, it repurchased $200 million of shares at a price of $115.45. We are not fans of reckless buybacks as managements so often seem to buy back their shares at exorbitant valuations. With the stock price north of $150 a couple of months later, all we can say is "hey, nice call."

Perrigo (PRGO) EQ Update- 3/20 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 maintain our earnings quality rating of 3- (Minor Concern)

PRGO received a huge tailwind in the 3/20 quarter as management estimated $90-$110 million in sales was pulled into the quarter from COVID-19 related demand. End-users of the company's products likely have their medicine cabinets stocked at this point, so consumer demand may be muted going forward. However, the next quarter could benefit from retailers restocking shelves. Now, investors are more focused on these issues than earnings quality items. Nevertheless, we continue to see a couple of red flags in the company's results.

- Accruals for customer programs continued to fall despite an increase in sales. Management has attributed the drain on cash flow by accruals for rebates, chargebacks, and shelf allowances to competition in the RX market. The fact that the allowances have declined due to more cash being paid out than accrued is an indication that earnings have received an artificial benefit from under-accruing. Customer programs were a smaller cash flow drain in the 3/20 quarter than the year-ago period as RX competition has reportedly begun to ease. However, we remain concerned that rebuilding these reserves may be a drag on earnings growth in upcoming periods.

- Amortization of acquired intangibles declined in the 3/20 quarter despite the addition of the *Prevacid* assets in November which we assume was due to older assets becoming fully amortized. Non-GAAP EPS growth was penalized in the quarter by the company's policy of adding back amortization to non-GAAP results. However, we remind investors that almost half of non-GAAP EPS disappears if intangible amortization is considered an expense. Given the company's reliance on acquisitions of ANDAs and brand rights for growth, we would argue the cost of these acquisitions should be considered an operational expense, and non-GAAP results are therefore misleading. Meanwhile, estimated useful lives remain at the high-end of ranges we usually see with the *Prevacid* assets being assigned a 20-year amortization period while recently acquired toothbrush accessory and oral care assets are being amortized over 25 years.

Customer Program Accruals Continue to Decline

We highlighted in our original review that the growth in PRGO's accruals for customer programs (chargebacks, rebates, shelf allowances) was lagging sales growth. His trend continued into the 3/20 quarter, as shown in the following table:

Table 1

	3/28/2020	12/31/2019	9/28/2019	6/29/2019
Sales	$1,341	$1,323	$1,191	$1,149
Accrued Customer Programs	$380	$394	$359	$385
Accrued Customer Programs Days	25.0	28.0	27.4	30.5

	3/30/2019	12/31/2018	9/29/2018	6/30/2018
Sales	$1,175	$1,195	$1,133	$1,186
Accrued Customer Programs	$380	$442	$416	$452
Accrued Customer Programs Days	28.8	34.4	33.4	34.7

	3/31/2018	12/31/2017	9/30/2017	7/01/2017
Sales	$1,217	$1,283	$1,231	$1,238
Accrued Customer Programs	$483	$420	$367	$370
Accrued Customer Programs Days	35.7	30.1	27.1	27.2

Accrued customer programs were higher in the 2018 time frame as a result of new product introductions. However, the year-over-year decline in customer program accruals days of sales in the 3/20 quarter marks the fifth straight year-over-year decline. PRGO only discloses the details of customer accruals in its 10-Ks. Following is the breakdown of the detail from the 2019 10-K:

	RX Chargebacks	RX Medicaid Rebates	RX Returns and Shelf Allow.	RX Adm. & Oth. Rebates	Rebates & Allow.	TOTAL
Balance at 12/31/2018	**$266.0**	**$36.4**	**$71.0**	**$44.5**	**$116.9**	**$534.8**
Acquired in Business Acquisition					$5.7	$5.7
Disposed of in Business Divestiture					-$4.1	-$4.1
FX					-$1.7	-$1.7
Provisions	$2,127.2	$47.9	$33.9	$116.5	$224.6	$2,550.1
Credits/Payments	-$2,157.4	-$56.7	-$33.4	-$126.3	-$227.3	-$2,601.1
Balance at 12/31/2019	**$235.8**	**$27.6**	**$71.5**	**$34.7**	**$114.1**	**$483.7**

**Note that shelf returns and allowances are recorded as reductions of sales rather than accrued programs so amounts do not compare directly to table 1.*

We can see that despite the increase in revenue in 2019, accruals for customer programs fell by almost 10% due to cash payments exceeding provisions. PRGO referenced the decline in accruals negatively impacting cash flow in the liquidity section of its 2019 10-K, stating that cash flow experienced *"$74.1 million decrease in cash due to the change in accrued customer programs due primarily to pricing dynamics in our RX segment, as well as timing of rebate and chargeback payments."* This essentially means that competition forced the company to lower the effective prices for customers by increasing rebates and chargebacks. Cash outflows to customers rose faster than accruals which implies that reported earnings were artificially inflated in the period. PRGO stated in the 3/20 10-Q that cash flow growth in the quarter benefitted from a decline in the consumption of cash by accrued customer programs in the current period. However, the accruals still consumed cash in the quarter as more was paid out than accrued.

Management noted that competition in the RX market is stabilizing, and we may see a reversal in the trend of the consumption of cash by accruals. However, the prolonged decline in accrual days may be an indication that there is still a need to boost the accrual reserves which could be a drag on future results.

Amortization of Acquired Intangibles Declined in the Quarter

Our original review documented how PRGO's non-GAAP earnings are highly dependent on adding back amortization from acquired intangibles. The following table shows acquired intangible amortization in net income, EPS, and the total non-GAAP EPS figure updated through the 3/20 quarter:

	3/28/2020	12/31/2019	9/28/2019	6/29/2019
Intangible Amortization in Net Income	$71.20	$79.80	$80.60	$74.40
Intangible Amortization in EPS	$0.52	$0.59	$0.59	$0.56
Non-GAAP EPS	$1.14	$1.06	$1.04	$0.86

	3/30/2019	12/31/2018	9/29/2018	6/30/2018
Intangible Amortization in Net Income	$76.50	$78.00	$85.50	$86.50
Intangible Amortization in EPS	$0.57	$0.57	$0.62	$0.62
Non-GAAP EPS	$1.07	$0.97	$1.09	$1.22

Intangible amortization rose in the 12/19 quarter, likely due to the addition of brand-named intangible amortization from the acquisition of the OTC rights to *Prevacid* in late November of 2019. PRGO is amortizing these rights over a 20-year period which seems somewhat long to us. While OTC *Prevacid* may still be on the shelf 20 years from now, new products will likely radically reduce its profit potential by then which makes for unrealistic cost-matching in our minds.

We assume the decline in amortization in the 3/20 quarter was due to older intangibles becoming fully-amortized. In the case of the 3/20 quarter, growth in non-GAAP EPS was penalized by excluding amortization expense. However, the table demonstrates once again that almost half of non-GAAP earnings disappear if the costs associated with acquisitions is considered. We believe this is very misleading given that acquiring OTC rights and ANDAs are a part of the company's growth strategy. With that in mind, we note that in the 3/20 quarter PRGO acquired toothbrush accessory company Steripod and silicon supplement brand Dexsil for $26 million and $8 million, respectively. Both brands are being amortized over 25 years. After the quarter-end, the company acquired the oral care assets of High Ridge Brands for $113 million. Amortization periods have not been disclosed.

Thermo Fisher Scientific (TMO) EQ Update- 3/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4+	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 upgrade our earnings quality rating to 4+ (Acceptable) from 3- (Minor Concern)

We downgraded our earnings quality rating on TMO after our review of the 9/19 quarter based on a jump in receivables and contract assets and minor benefits from cuts to bad debt allowances and warranty expense. While the allowance cut and lower warranty expense remained mild tailwinds in the 3/20 quarter, the company more than beat estimates without them. Also, our concern regarding receivables has decreased prompting us to upgrade our rating.

- The allowance for doubtful accounts fell to 2.2% of gross receivables from 2.7% in the year-ago quarter and 2.3% in the previous quarter. Provision expense jumped by $8 million but this was largely offset by a $6 million increase in write-offs. It would still take approximately 5 cps to return the allowance percentage back to the high 2% range.

- Lower warranty expense added almost a penny per share to EPS in the quarter.

- Accounts receivables DSO jumped by more than 3 days over the year-ago quarter and contract assets jump by more than a day. However, this could have been driven by testing revenues jumping late in the quarter which greatly reduced our concern.

- Inventory DSI jumped by 5.7 days. Such an increase would usually be a red flag, but the increase was centered in raw materials and is likely due to the company gearing up for future test demand.

- TMO entered into an agreement to buy QIAGEN for $11.5 billion on March 3. Details of the transaction were not disclosed in the 10-Q but we will review the allocation of the purchase price and treatment of intangibles when information is available.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

Disclosure

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