BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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MOWI (MHGVY) Update
Maintain BUY

We are maintaining our BUY rating on MOWI (MHGVY). The quarter before COVID-19 had very strong pricing that declined rapidly near the end of the first quarter. As markets have been reopening in 2Q, pricing has begun to recover. Also, the company's consumer products sales have been doing very well with restaurants closed and many fresh meat counters in US supermarkets closed for a period of late 1Q and early 2Q. We still believe that this is a play on volumes doubling and tripling over time with strong pricing due to demand growth, improved tech for salmon health, and vertical integration where superior pricing and lower costs can be achieved. Quarter to quarter, results will likely always be lumpy. A change of €0.1/kg for EBIT is worth about €40 million in EBITDA for a company that reported €875 million last year. And, the change can come from a combination of pricing changes, volumes creating more/less operating leverage over fixed costs, or operating costs rising or falling. So, this remains a tough company to model.

What is interesting is much of the decline in the stock comes solely from weakness in the Norwegian Krone (NOK) relative to the dollar. MOWI's operations are more tied to the Euro and Dollar – but its stock is priced in NOK. Historically, the NOK trades about 6:1. Since 2015, the exchange rate has been 8-9:1. During the COVID-19 issues, the NOK reached 12:1 briefly and is still running between 10-11 to 1. The stock is down 19% in Norway, but 28% in the US-based on the currency. We still believe one of the catalysts here will be the NOK recovering – it doesn't even need to recover back to the 6:1 historic level:

NOK/USD	ADR Price	Appreciation
10/1	$18.16	3%
9/1	$20.17	15%
8/1	$22.70	29%

We think many catalysts point to a swift return for salmon prices coming from demand. The company is operating with some extra costs at this time – higher air freight cost and some COVID-19 related mitigation measures – but the company is running at normal levels:

- **Key metrics that hurt late 1Q and early 2Q**
  - Food Service hurt by restaurants being closed and US supermarkets closing meat counters. That hurt demand and pricing.
  - Health issues with 2018 generation fish – these had more issues than recent generations and resulted in higher costs to grow the fish overall (increases in feed, treatments, longer to grow). That made 2018 generation fish higher cost overall and that cost is released through the income statement when the fish are sold.
  - Health issues with fish also mean – lower superior share grades and lower prices and often smaller fish weight which lowers pricing and doesn't leverage the fixed costs of raising a fish.
  - Large percentage of Chile fish sold to Brazil which has lower prices than the US.
  - Distribution issues with China and Asia, which saw the COVID issues first.

    - Offsetting some of this was record business for MOWI's consumer business as people shifted to buying salmon for home use over restaurants.

- **How the numbers played in 1Q y/y – Operating Income down from €196mm to €109mm**
    - Harvest volume 83,100 tons against guidance of 84,000. Basically, at guidance but down 21,000 tons y/y after large harvesting in 3Q19 and 4Q19 – that was €27.5mm.
    - Pricing down 0.5 Euros per KG due to issues mentioned above. That €41.5mm.
    - Higher embedded costs being released from selling gen-18 fish was €18.0mm.

- **What is Driving 2Q – Good and Bad**
    - Gen-18 fish should largely be gone in 2Q and Gen-19 has been doing much better so the rest of the embedded costs should be released in 2Q.
    - Harvest volumes are expected to rise to 102,500 tons – which would exceed 2Q19 by 4%.
    - Pricing fell further in April and into May. China and Asia are now open – demand in some areas is now exceeding 2019 levels. MOWI is seeing pricing start to rebound in France, Spain, and Germany as those countries reopen.
    - Contract sales will offset some of the weakness in pricing, but Gen-18 may still cost them some superior share grading and premiums.
    - Consumer Products should see strong demand and rising operating income. The record demand continues there and MOWI will have more fish to put through that channel. Low margin contracts in Europe held back profits in 1Q, but as they exceed the volumes contracted for – they should achieve higher profits per unit as the incremental sales occur at higher prices.
    - High freight costs due to fewer planes flying are showing up in 2Q. This hasn't been an issue for China but getting salmon from Chile to the U.S. has seen elevated costs for airfreight.
    - Volume should be fine for 2Q, costs issues should show recovery too. Pricing fell to multi-year lows through the first 5 weeks of 2Q. Prices are rising now but should still be a drag the primary drag for this quarter.

- **Catalyst – Volumes Are Rising Slowly Still – Good for Pricing**
  - MOWI is reporting industry growth projections for 2020 of 2%-4% and for 2021 of only 2%.
  - This should keep the market tight as demand is still growing and COVID displacements are starting to recover.
  - MOWI is holding its 450,000-ton forecast for 2020 (up 3.2% vs 2019), which will be heavier in 3Q and 4Q.
  - Gen-19 fish are healthier and gaining weight faster than Gen-18. Bigger fish should add to volumes too.

- **Catalyst – Pricing Historically has Held Well and Recovers Fast**
  - Salmon is still a very small part of the overall protein market (about 4%-5% of seafood consumed and seafood is only about 25% of the total protein market). Demand has been rising for decades even during recessions.
  - Salmon also has appeal for health reasons, diet reasons, environmental reasons (it takes less feed to grow salmon vs. beef, pork, or chicken).
  - MOWI can supply essentially most of its own feed now – that lower costs, but also gives them documentation to show exactly what the fish ate throughout its life and can sell that fish for a premium price.
  - MOWI has several contracts in place with buyers that smooth out the commodity nature of fish pricing. It can also earn superior share grades for premium pricing too. That has covered a great deal of its fish historically and 1Q was an anomaly to only achieve about 90% price achievement – over 100% is more common for MOWI.

- **Catalyst - Consumer Products Continue to Expand – Creating More Vertical Integration**
  - Consumer products include smoked salmon, individual-sized filets, sushi, and other items processed for easier cooking/eating at home.
  - It allows for higher prices and less price sensitivity tied to commodity prices.
  - MOWI delayed 2Q plans for MOWI-brand launches in the US and France.
  - Demand for consumer products is still hitting new records, and the launches will come this year.

- Consumer products should see higher earnings in 2Q with rising demand and also volumes in excess of some low-price contracts in Europe. The incremental sales should happen at better prices and profit levels.
- Distribution issues from Chile faced by the industry have been smoothed out by running much of that salmon through the US consumer products plants and then out to the US retail market.
- This is still an area in its infancy, particularly in the US. MOWI built a consumer market that helped double per-capita salmon consumption in Germany. US consumption per-capita is still very low so boosting that should drive results much higher.
- Germany was at 500-600 tons of consumer product and now eats over 7,000 tons. Total German consumption after doubling is 150,000 tons. The US is starting is at 375,000 tons. Seeing the per-capital double in the US would cover a significant rise of new volumes.

- **Rest of 2020 Guidance**
  - Growth should require working capital to increase by €90 million – a drain of €165 million from 1Q.
  - Capital spending includes several growth items to boost fish quality/health and help pricing going forward. MOWI still has €210 million to spend.
  - Interest and Taxes are expected to consume €120 million more this year.
  - MOWI has €580 million of cash and liquidity on hand to meet that €495 million outflow of cash.
  - There is still about 367,000 tons to harvest and sell, which is 333.3 million kgs.
  - Normally, MOWI earns €1.50-€2.50 per kg in operating income and there is another €40 million per quarter in depreciation/amortization. So, the sensitivity is huge here.
  - Q2 should see some lower costs, and pricing is starting to rebound – but should be impaired. EBIT could be €0, making EBTIDA about €40 million.
  - Q3 and Q4 should be solid as costs decline more, higher volumes offset other fixed costs, and pricing could be near normal levels, and the Gen-18 fish should be gone. That would be EBIT of €1.50-2.00 per kg. And would set MOWI up for EBITDA of €690 for the year (€540 for the last

nine months). Every €0.1 per kg change for Q3 and Q4 is worth about €24 million +/- from that €540 million.

Our conclusion is that MOWI should have more than enough cash and liquidity to handle its cash needs. In addition, it will generate positive cash flow in the 3Q and 4Q when the larger cash needs are required for taxes and working capital build. It has no material debt payments for a couple more years. While 2Q is likely to be ugly, based largely on pricing, it is helping accelerate MOWI's longer-term plans of boosting consumer product sales. We would not be surprised to see the company either skip 2Q's dividend or reduce it substantially. The dividend for 3Q and 4Q appear more likely but may also decline from the current €133 million/Q level. We still see the long-term story here in-tact and believe several years of work to vertically integrate and improve fish health are boosting margins and volumes. This will always be some lumpiness due to a score of variables – but the volumes appear poised to keep rising at increasing margins plus there is a currency variable that can be a nice tailwind too for the stock price.

RealPage (RP) EQ Update- 3/20 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

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

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

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

We are maintaining our earnings quality rating of 2- (Weak)

The company had its usual adjusted EPS beat of 1-cent. The normal levers did not all help as much in 1Q20, so it may be getting tougher for RP to hit forecasts. It did lower guidance after 1Q, even after noting it saw very minimal impact from COVID-19 and a rapid V-shaped recovery.

As we describe in our initial reports, we think RP's adjusted EPS is considerably inflated by acquisition accounting. Not only does it not amortize much more than a fraction of the purchase price, it adds back the small amount that is amortized. While acquisitions are a way of life at RP – they also add back all costs related to the transactions, integrations, legal issues, and stock compensation. Guidance is for $1.74-$1.84 in adjusted EPS. Without the adjustments, GAAP EPS is likely closer to 50-cents and if they expensed the purchase prices of acquisitions, EPS would be negative.

- Cutting Product Development costs in dollar terms has been adding 1-2 cents to quarterly EPS. In 1Q, the cost actually rose $2 million and it became a 1.6-cent headwind.

- Product Development costs as a percentage of revenues still fell by $3 million and provided 2.4-cents to 1Q EPS. Normally, this adds 3-5 cents to RP's EPS.

- Bad Debt Reserves have also started to increase and cost RP about 1-cent of EPS in 1Q20 and 4Q19.

- Capital spending been flat for 3-years despite total assets rising 500% since 2015. Deprecation is flat to down as well. We think many signs point to RP using fully depreciated computers and equipment as a tech company. This appears to be adding 1-2 cents to quarterly EPS.

- RP saw a small bump in capital spending in 1Q and added that it expects to buy more computers to allow its staff to work at home in 2Q. These may be signs that depreciation may stop being a tailwind for EPS growth too.

- Deferred Revenue DSOs continue to fall and are down 15 days now over the last 3 years. That should also make it tougher to hit revenue forecasts as RP relies more heavily on current-quarter sales.

Earnings Growth from Cutting Product Development Is losing Steam

1Q20 was the first time in several quarters where adjusted product development costs did not drop in absolute dollar terms. But they did decline as a percentage of sales again. RP backs out stock compensation and assumes a 26% tax rate:

Cuts to R&D	1Q20	4Q19	3Q19	2Q19	1Q19
Cuts in $ terms	-$2.0	$2.7	$0.8	$2.0	-$0.5
EPS help	-$0.02	$0.02	$0.01	$0.02	$0.00
Cuts in % of non-GAAP sales	$3.0	$5.9	$4.3	$5.6	$3.8
EPS help	$0.02	$0.05	$0.03	$0.04	$0.03

In 1Q20, the actual spending before stock compensation rose in dollar terms by $2 million and was a drag of 1.6-cents on EPS. However, RP still saw the percentage of sales decline by over 100bp and add 2.4 cents. For the quarter, RP beat forecasts by a penny – and they still picked it up here.

Bad Debt Expense Had Been Helping RP Hit Forecasts Too – That's Fading of Late

Bad Debt Reserves	1Q20	4Q19	3Q19	2Q19	1Q19
Reserve	$10.6	$10.3	$8.6	$7.8	$7.9
Accts Rec.	$131.6	$143.2	$131.4	$128.1	$125.1
% of Reserve	7.47%	6.69%	6.11%	5.75%	5.97%
EPS help(hurt)	-$0.009	-$0.007	-$0.004	$0.005	$0.008

There isn't discussion about this, but the reserve has been rising and is now costing RP about 1-cent in EPS in 1Q20 and 4Q19.

We Continue to Think RP Is Underinvesting in the Business and Helping EPS with Low Depreciation

RP grows through acquisition and allocates much of the purchase price to intangibles. It has grown total assets 500% in the last 5-years and yet capital spending is flat:

	2019	2018	2017	2016	2015
Capital Exp.	$51.5	$50.9	$49.8	$75.2	$33.4
Total Assets $B	$3.0	$2.1	$1.5	$0.8	$0.6

This is supposed to be a tech company. About half the PP&E is software and another quarter is data processing/communications equipment. Gross PP&E has only risen $110 million since 2015, net PP&E is up $36 million as the company has quintupled in size. They depreciate these assets over 3-5 years. It just doesn't pass the eye-test that capital spending can be flat.

In 2019, the amortization of software rose – but depreciation continues to hold flat or decline:

	1Q20	4Q19	3Q19	2Q19	1Q19
Depreciation	$7.4	$7.5	$7.5	$7.7	$7.5
Amortiz. Software	$4.1	$3.9	$3.9	$3.8	$3.2

Total capital spending is only exceeding depreciation and amortization by 10% or $5 million. We think RP is picking up some EPS by using older equipment after it is fully depreciated as well as software. That can be done for short periods of time, but it seldom lasts. 1Q20 saw capital spending actually rise $2.4 million. RP also pointed out it will spend $3 million largely in 2Q for new computer equipment to help its employees work remotely. This company is used to beating forecasts by 1-2 cents. That amounts to only $1.3-$2.6 million in depreciation and amortization. We think this could be an area of headwind for several years if the need to upgrade is starting to occur.

Deferred Revenue Days Continues to Decline

DSOs for deferred revenue used to be over above 60 days a couple of years ago. It has been falling steadily including in 1Q20:

DSOs	1Q	4Q	3Q	2Q
2020/2019	48.4	51.5	47.5	49.9
2019/2018	50.6	52.6	49.0	51.3

This puts the company more at risk of needing to current quarter business to meet forecasts. While COVID-19 hurt its vacation rental business, the company noted that the bulk of its apartment rentals saw minimal impact in 1Q. In 2Q, there was a short period when people move and ended up signing a new lease at their current location. RP thinks it has rebounded well as a V-shaped recovery only a couple weeks later. It also has seen a pop in revenue from people paying rent online in April and May. The company still cut its revenue forecast by 3%-5% for the year largely from disruptions at the end of 1Q and start of 2Q.

We will allow for some COVID-19 weakness, but this metric is still showing negative trends that were well in place long before the shut-down.

Grubhub Inc. (GRUB) EQ Update- 3/20 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
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We are maintaining our earnings quality rating of 2- (Weak)

After 1Q20 results, Uber announced it was making a push to acquire GRUB in an all-stock deal. The initial discussions are for 2.15 shares of Uber for each share of GRUB – (we are now seeing 1.9 shares also). We won't comment on the likelihood of a deal or potential reasons behind it. But we will focus on the basic accounting issues we see and key risks. GRUB's 1Q results showed a surge in volumes for restaurant customers and dining users for its website. It also showed weak returns overall.

GRUB expects to channel much of the potential profits back into the business to support the business in 2Q. This will happen through a series of discounts allowing diners to earn more loyalty points and buy food at a discount from various restaurants along with marketing.

- **An Uber purchase of GRUB seems likely to cost about $6 billion with nearly all of that price being assigned to intangible assets.**

- **GRUB's best year for results was 2018 when it posted Adjusted EBITDA of $234 million, that would give an ROI on a $6 billion deal of only 3.9% - that seems too low to support that level of intangible assets.**

- **Adjusted EBITDA adds back stock compensation. As the stock fell from $146 in 2018 to $30 before Uber came along this week, most of the options are out of the money and we think employees would be asking for more cash wages.**

Many of the options would remain out of the money with the potential Uber deal.

- **Using normal EBITDA would cut the ROI on a merger to 2.5% or lower.**

- **Government actions are boosting costs or limiting fees. California, in particular, has capped fees that GRUB can charge in some cities and the company noted business volume is lower.**

- **The bigger issue from California is labeling all workers as employees instead of independent contractors unless the company can prove otherwise.** Both Uber and Grubhub have been in court for this issue many times since the new law took effect in January. Whether they win or lose – they are paying legal fees and that is hurting results too.

- **Grubhub's results before the shut-down were already falling rapidly in terms of profit per transaction and total volume growth.** The company agrees with us that delivery services are becoming a commodity and the incremental customer adds require more investment for a lower return.

- **The shut-down has caused GRUB to sign up many new restaurants and diners. It has also caused it to invest heavily in the business via discounts and loyalty rewards. That may have consumed its sales pipeline. The net is business volumes are strong – but profits are expected to vanish in 2Q.**

- **We believe much of the new business will wane after restaurants reopen. Also, restaurants have learned to deal with takeout without the delivery services. If many of the new costs remain, we think GRUB faces a potential impairment on its $1.5 billion in intangibles even if the Uber deal doesn't happen.**

- **We also think investors should be aware that $354 million in intangibles are related to restaurant relationships. Many restaurants are closing or will close some locations. That problem could lead to an impairment of that asset too.**

Potential Uber Purchase May Expose Some Accounting Quality Risks

GRUB has essentially 92 million shares outstanding and UBER stock has been bouncing between $27-$33. Based on 1.90-2.15 shares of UBER that would be a purchase price of $4.7-$6.5 billion. We will call it $6 billion for this exercise.

Using the GRUB balance sheet from March 31:

- Current Assets $771 million - Current Liabilities $306 million = $465 Working Capital
- PP&E $189 million + ROU assets $102 million – LT Debt $806 million = -$515 million

That is close enough to be considered a wash at this point to mean that the full $6 billion in purchase price for GRUB would be allocated to intangible assets. Currently, GRUB has $1.5 billion in equity against $1.5 billion in intangibles that it acquired allocated as:

GRUB Intang. Assets	Gross	Net	Amort. Life
Goodwill	$1,008	$1,008	Indef.
Restaurant Relations	$493	$354	17.5 yrs
Diner Acquisition	$48	$26	5.0 yrs
Developed Tech	$36	$18	4.7 yrs
Other	$3	$0	n/a
Trademarks	$90	$90	Indef.
Total	$1,677	$1,496	

GRUB hasn't made a material acquisition since 2018 and the company has grown organically since then. Thus, we would expect the intangible assets that are amortized to increase with a merger. However, it seems likely that goodwill would become the bulk of the $6 billion in assets. We would expect the company to add back any amortization in determining the actual return on investment. However, this full $6 billion in intangibles would also be tested for impairment annually. Look at the results GRUB has been posting:

GRUB	TTM	2019	2018	2017
EBITDA	$76	$109	$179	$151
Adj. EBITDA	$152	$182	$234	$184
Cash from Ops	$142	$183	$226	$154

Adjusted EBITDA adds back an enormous amount of stock compensation. We have talked about this as a problem because GRUB stock has been underwater for some time. It was granting options at $63 in 2018, $77 in 2019, and $50 in 2020. RSUs granted were $94, $70, and $51 over that same time. During that same time, GRUB stock crashed from $146 to $30 until Uber's interest this week. In our view, employees are more likely to ask for cash wages when a stock is falling. With that in mind, we think investors should be skeptical of the quality of adjusted EBITDA. Most of those options would not be exercisable under the currently discussed purchase price – those employees may want more cash wages from Uber if a deal is completed. That may be true also looking at Uber not posting positive cash flow from operations.

The best possible return GRUB assets have been posting is a 3.9% ROI - $234 million of Adjusted EBITDA against a $6 billion potential purchase price. $150 million may be a better measure which is a 2.5% ROI. How will a low-single-digit ROI justify the carrying value of $6 billion in tangibles as they get tested for impairment?

More Risks to Cash Flows Come from Actual and Potential Government Actions

There are pushes coming that could raise the operating costs for Uber and Grubhub and limit what they can charge. Wherever these governments are successful, cash flow seems likely to decline. During the time spent litigating these matters, the companies should see higher costs just for that.

Grubhub notes in its 10-Q that is has modified its bank agreement to define EBITDA as adding back litigation costs of up to 25% of consolidated EBITDA. That happened after 1Q20 saw Grubhub recorded a $12.5 million reserve to deal with settling lawsuits related to a law that went into effect in January 2020 (AB5).

AB5 in California targets employers who have drivers and other types of workers classified as independent contractors rather than employees. Under the law, Grubhub driver is considered an employee of Grubhub unless the company can prove otherwise. This opens up the possibility of minimum wage laws, insurance, and FICA issues. Already, both UBER and GRUB are seeing many instances where the state is classifying its drivers as employees and they have to prove they are not. This is starting to cost money. UBER's 10-K has a better description of the process:

UBER 10K:

> *"The Company has existing litigation, including class actions, PAGA lawsuits, arbitration claims, and governmental administrative and audit proceedings, asserting claims by or on behalf of Drivers that Drivers are misclassified as independent contractors. In connection with the enactment of California State Assembly Bill 5 ("AB5"), the* ***Company has received and expects to continue to receive - in California and in other jurisdictions - an increased number of misclassification claims.***
>
> ***AB5*** *In January 2020, AB5 went into effect. AB5 codifies a test to determine whether a worker is an employee under California law. The test is referred to as the "ABC" test, and was originally handed down by the California Supreme Court in Dynamex Operations v. Superior Court in 2018.* ***Under the ABC test, workers performing services for a hiring entity are considered employees unless the hiring entity can demonstrate three things****: the worker (A) is free from the hiring entity's control, (B) performs work that is outside the usual course of the hiring entity's business, and (C) customarily engages in the independent trade, work or type of business performed for the hiring entity.*
>
> ***The Company has received lawsuits and governmental inquiries relating to AB5, and anticipates - in California and in other jurisdictions - future claims, lawsuits, arbitration proceedings, administrative actions, and government investigations and audits challenging the Company's classification of Drivers as independent contractors and not employees."***

Grubhub has the same issues and as noted above booked a $12.5 million reserve to settle this increase in challenges:

GRUB 10-Q:

> "*in January 2020, California State assembly Bill 5 ("aB5") went into effect, which codifies a test to determine whether a worker is an employee or independent contractor under California law. in light of aB5,* ***the Company expects to continue to receive an increased number of misclassification claims.***
>
> *However, there is no assurance that any claim will not be combined into a collective or class action. During the three months ended March 31, 2020,* ***the Company recorded a $12.5 million accrual related to the settlement of certain of these matters****."*

In our view, even if the banks let them add back these costs, they will still require cash payments. That is going to reduce cash flow in computing the returns generated by GRUB and supporting its intangible asset valuations.

On the 1Q20 Conference Call, GRUB also noted that there are government agencies capping the fees it can charge too. That seems likely to make some business uneconomic to pursue or it will need to reduce marketing costs to offset lower fees and make the Grubhub proposition to restaurants less attractive:

GRUB 1Q20 call:

> ***"And the fees we collect from our restaurant partners are subsequently capped like the emergency legislation currently enacted in San Francisco, Seattle and a few other jurisdictions.***
>
> ***We must fund deliveries by increasing the consumer fees and spending less on marketing in the diners, both of which would reduce overall orders. We've already seen negative impacts of this in San Francisco."***

Even without UBER Deal – We Expect Some Write-downs in GRUB Intangibles

Goodwill is an obvious place to consider if GRUB needs an impairment. Goodwill is just over $1 billion on the books and is not being amortized. GRUB is reinvesting potential profits back into the business in the form of discounts for diners. For example, someone may get $10 off a $30 order or $5 off an order placed with a new restaurant partner. GRUB is paying the restaurant the full price for the food. These types of actions started making an impact on results in 1Q20, but results were declining before that.

The profit per transaction has been falling sequentially and y/y:

Adj. EBITDA/Order	1Q	4Q	3Q	2Q
2020/2019	$0.45	$0.58	$1.28	$1.24
2019/2018	$1.09	$0.98	$1.57	$1.78

The growth rate for order volume has also been falling and turned negative in 1Q:

y/y DAG Growth	1Q	4Q	3Q	2Q
2020/2019	-1%	8%	10%	16%
2019/2018	19%	19%	37%	35%

And the cash flow overall at the company is falling fast too. This Adjusted EBITDA figure adds back litigation costs like we described in the prior section and stock option compensation:

Adj. EBITDA	1Q	4Q	3Q	2Q
2020/2019	$21.0	$26.7	$53.8	$54.7
2019/2018	$50.9	$42.1	$60.1	$67.4

These are some steep declines in the business and 2Q is expected to be worse. After 1Q results GRUB noted:

> *"Grubhub is using nearly all of our profits in the second quarter to generate as many additional orders for our restaurant partners as possible. We hope that the darkest days are behind our restaurant partners and they can start focusing on the recovery."*

Expect basically a zero for adjusted EBITDA in 2Q as GRUB boosts advertising, gives diners discounted deals on orders, works with restaurants on its system with faster payments and alerting diners they are on the GRUB site. GRUB is also ramping up payments to drivers for sick time. **The company notes it could be generating meaningful adjusted EBITDA at this time without all these special items.**

There is no doubt that GRUB signed up many new restaurants and diners as a result of the shut-down. However, even it notes that it basically drained its pipeline of new growth already. Also, as we noted in the initial EQ report on GRUB – the incremental restaurants and diners were requiring higher amounts of promotion and bringing lower volumes. Thus, costs were rising and profit per transaction was coming down. **GRUB confirmed this on the conference call saying the shut-down accelerated the commoditization of delivery service and the push to lower prices and costs. We agree – how do they reverse this and tell restaurants to pay more for advertising now? Their call reports that they have spent heavily to attract new diners with discount programs – how does that go away?**

GRUB's sales pitch may be blown at this point. It would approach a restaurant doing lots of dine-in business and show stats that it could increase sales by 5-15 orders per day, which helps a restaurant cover overhead costs for wages and utilities. Now, with restaurants going to 100% carry-out, they have developed their own systems for handing that side of the business and can offer it to customers at a lower price than GRUB. They signed up rapidly with GRUB and Doordash and others to get as much carry-out coverage as possible. What we see anecdotally now at our local restaurants is the vast majority of business is coming from customers doing carry-out instead of using a delivery service.

Many of the newer restaurants that signed up may not lend themselves to delivery experience very easily and are more likely to see a huge drop off in GRUB business when they reopen. People will want to get a full dining experience – without a salad, entrée, and dessert all coming at the same time and then washing their own dishes. Also, they will likely want a full menu that comes with dining out unlike the strippeddown menus many restaurants are offering for take-out to emphasize food that travels better and/or reheats better.

We think the profit squeeze that has been evident long before moving restaurants to 100% carry-out orders will continue to make it tougher to avoid a goodwill impairment.

Also, restaurant relationships are a $354 million balance sheet item. GRUB amortizes that over 17.5 years. How many restaurants are going out of business during the shut-down? How many restaurants will close at least some locations during this? That seems like another intangible item that could face an impairment in the near future – especially if the even the business that GRUB retains comes it at much lower profit figures.

Mohawk Industries (MHK) EQ Update- 3/20 Qtr.

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3+	3+

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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)

As usual, MHK's quarter contained unusual items working both ways for the company.

- The allowance for doubtful accounts as a percentage of gross trade receivables fell to 4.0% from 4.2% in the previous quarter and 4.2% in the year-ago quarter. If the allowance had remained a constant percentage, we estimate it would have shaved about 2.4 cps off EPS in the quarter. Given the current circumstances, we believe an increase in the reserve will prove necessary which would be a drain on profit growth in upcoming periods. The reserve percentage was in the mid-5% range as recently as 2016. It would take more than 25 cps in provision expense to boost the allowance back to that level. For reference, the allowance percentage was near 10% at the end of 2009.

- We highlighted in our review of the 12/19 quarter that the company received a 13 cps tailwind from lower amortization of costs to obtain contracts. However, this reversed in the 3/20 period to an approximate 5 cps headwind.

- Lower stock compensation expense added almost a penny to EPS in the period.

- MHK's adjusted effective tax rate fell to 20.0% from 23.2% a year ago due to the geographic mix of profits as well as "the inability of the company to make a reliable estimate of its annual effective tax rate." Under ASC 740-020, the company must make an estimate of its effective rate for the full year and then apply that rate to the quarter. However, management stated that it was unable to estimate its annual effective tax rate for the year due to "the variability of the rate as a result of small changes in forecasted income, fluctuations in annual pre-tax income and loss between quarters, and the effects of being taxed in multiple tax jurisdictions." Therefore, it applied the actual effective rate from the quarter. The lower effective rate would have added about 7 cps to earnings in the quarter.

- As of 3/20, MHK had $263 million in cash on hand and over $900 million available under its Senior Credit Facility. After the quarter-end, the company borrowed an additional $500 million under a new Term Loan Facility and entered an underwriting agreement to sell $500 million in 3.625% Senior Notes due 2030. It also successfully amended its senior credit facilities to raise the maximum allowance Consolidated Net Leverage Ratio from 3.75 to 4.75 as well as expanding the cash that can be netted against indebtedness in the calculation to $500 million from $300 million. Net debt to adjusted EBITDA at the end of the quarter was 1.7. A dividend is not a concern and the company seems well prepared to weather a slowdown in sales.

Ball Corp. (BLL) 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)

BLL's results remained strong in the first quarter as its beverage packings segment benefitted from pantry stuffing activity and aerospace remained healthy. While results benefitted from an unusual cut to bad debt allowances in the quarter after a buildup in the previous quarter (discussed below), the pace of factoring continues to slow and we are less concerned about the quality of recognized revenues.

- The company's pace of factoring receivables continues to slow as factored receivables days of sales rose by just over 3 days versus the 6 to 8-day increases seen in the previous three quarters. This was largely offset by a 2.7-day decline in receivables on the balance sheet.

- Unbilled receivable DSOs based on total sales rose by less than 3 days versus the year-ago quarter. However, the 17% increase in unbilled receivables fell well behind the 31.7% increase in aerospace sales which is a good sign for the quality of revenue recognition in the quarter.

- The allowance for doubtful accounts fell to 0.4% of gross receivables (trade+unbilled) versus 0.6% a year ago. The company built the allowance to an unusually high 1.4% in the 12/19 quarter before taking it down in the 3/20 period. The company does not disclose provision expense and write-offs, so we can't tell the exact impact on expenses in the period. However, if the allowance percentage had remained constant from the 12/19 quarter to the 3/20 quarter, we estimate it would have taken about 3.5 cps off earnings in the 3/20 quarter.

- Inventory DSI jumped by almost 5 days over last year's first quarter but this was completely driven by a jump in raw materials and supplies. Management attributed this to the timing of payments to stockpile metal inventories to meet rising demand in North America. Capex will rise in 2020 to $800 million to support the expansion of aerospace facilities and beverage can production capacity. This plus the working capital increase result in a 2020 free cash flow forecast of $500 million. This is more than sufficient to cover the approximate $200 million dividend payment, but the company has suspended the share buyback until further notice. With $800 million in cash on hand, over a billion in credit lines, and no debt maturities until 2022, the company has ample liquidity to rise out short-term disruptions.

- As we noted in our last review of BLL, the company warned in the 10-K that its restructuring of the AMEA and Asia Pacific beverage packaging reporting units would result in $62 million in goodwill, some or all of which might be subject to write off. The company ended up writing off the entire amount in the 3/20 quarter.

Zimmer Biomet (ZBH) EQ Update- 3/20 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

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

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

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

We maintain our earnings quality rating of 2- (Minor Concern)

- We see evidence that the company may have significantly accelerated the sale of receivables to a European third party. While we will be doing more work to get greater clarity on the issue, our initial thoughts are that adjusted receivable DSOs could have climbed by more than five days in the 3/20 quarter from the increased extension of receivables to customers. This is considerably different than the 3-day decline in DSOs on the balance sheet would indicate.

- Our last review of the company highlighted ZBH's warning that the goodwill related to its EMEA and Dental reporting units remained susceptible to write-downs. The company followed up this quarter by writing off $612 million in goodwill ($470 million in EMEA and $142 million in Dental). The company blamed COVID-19 for impacting both deteriorating operational assumptions as well as the decline in the company's stock price which forced the use of a higher discount rate used to calculate the fair value of intangibles. ZBH also warned that the impairment testing done during the quarter indicated that the fair value of the goodwill related to the Americas CMFT unit was only 5% greater than carrying value leaving open the possibility of more write-downs if future results disappoint.

- We note that the company no longer discloses detail regarding its pension plan expense in its 10-Qs. However, it does note in the MD&A section that the $3.5

million beneficial swing in other income was "**primarily related to certain components of pension expense,** changes to the fair value of our equity investments and re-measuring monetary assets and liabilities denominated in a foreign currency other than an entity's functional currency, partially offset by foreign currency forward exchange contracts we entered into to mitigate any gain or loss related to remeasurement."

Did Receivables Factoring Increase Substantially in the Quarter?

We have discussed in the past that ZBH has factoring programs under which it sells accounts receivable to third parties in the US, Japan, and Europe. The company maintains responsibility for collection under agreements in the US and Japan but does not under its agreement in Europe. ZBH discloses the amount of receivables sold but still outstanding at the end of each period in the US and Japan, but not those sold to the European third party. We have monitored the trend in both balance sheet receivables as well as receivables sold in the US and Japan but still outstanding at period end. This data is shown in the table below:

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Trade Receivables	$1,039.1	$1,363.9	$1,150.8	$1,247.1
Outstanding Sold Recs in US and Japan	$421.8	$270.2	$372.6	$378.1
Receivables Adjusted for US and Japan Factoring	$1,460.9	$1,634.1	$1,523.4	$1,625.2
Trade Receivables Days of Sales	53.0	59.0	55.9	57.1
Factored Receivables Days of Sales	21.5	11.7	18.1	17.3
DSOs Adjusted for US and Japan Factoring	74.5	70.7	74.1	74.4

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Trade Receivables	$1,225.3	$1,275.8	$1,262.7	$1,335.3
Outstanding Sold Recs in US and Japan	$390.4	$365.9	$341.8	$338.9
Receivables Adjusted for US and Japan Factoring	$1,615.7	$1,641.7	$1,604.5	$1,674.2
Trade Receivables Days of Sales	55.8	56.7	63.2	60.5
Factored Receivables Days of Sales	17.8	16.3	17.1	15.4
DSOs Adjusted for US and Japan Factoring	73.6	72.9	80.4	75.9

These figures do not appear alarming. Balance sheet receivable days fell from 55.8 last year to 53.0 in the current quarter. Receivables sold but outstanding in the US and Japan rose from 17.8 to 21.5 in the same period resulting in an approximate 1-day increase in adjusted DSO- so far nothing to be concerned about.

However, ZBH also discloses the face amount of receivables sold “to third parties” in the period which is shown below:

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Quarterly Receivables "Sold to Third Parties"	$561	$732	$789	$797

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Quarterly Receivables "Sold to Third Parties"	$799	$764	$682	$644

We have assumed in the past that this amount included receivables sold in Europe as well as the US and Japan. However, we noticed that the numbers above do not seem to match the company’s commentary on cash flow in the liquidity section of the 10-Q.

Cash generated by receivables jumped significantly in the 3/20 quarter:

	3/31/2020	12/31/2019	9/30/2019	6/30/2019	3/31/2019	12/31/2018	9/30/2018
Cash from Recs- Cash Flow Stmt	$290	-$203	$80	-$21	$51	-$24	$60

With regards to the cash contribution of receivables in the quarter, management stated that cash flow in the 2020 period ***“also benefited from incrementally higher sales of our accounts receivable to a third party…”***. However, as the table above shows, cash generated by receivables sold to third parties actually declined sequentially by $170 million. For the company to have experienced a meaningful sequential increase in cash generated by receivables, we would have expected to see the face amount of receivables sold to third parties in the 3/20 quarter climb to north of $800 million. This makes us wonder if the “sold to third parties” figure only contains amounts sold in the US and Japan and does not include receivables sold to the third party in Europe.

We have always known that our adjusted DSO figure did not take the sold European receivables into account, but given the relatively stable trend in adjusted DSOs, we have assumed they tracked fairly closely with the US and Japan. However, if the “sold to third parties” figure does not include Europe and amounts sold in the US and Japan are down by $170 million it would imply there was at least an approximate $200 million jump in receivables sold in Europe to generate an “incrementally higher” amount of receivables sold to third parties. Thus, we estimate the jump in adjusted

DSOs in the table above could be understated by 8 days or more. *We were not able to contact the company prior to publication but hope to clarify this issue and report in a future update.*

On a related matter, the company introduced cautionary language in the 10-Q about its ability to collect receivables given the current environment:

> *"Due to COVID-19, starting in the second quarter of 2020, our operating cash flows may be negative due to the expected decline in net sales and* ***collection delays,*** *as well as the continuance of fixed operating expenses.* ***Since March 31, 2020, with minimal exceptions we have continued to collect on outstanding receivables, but the collections may not be enough to generate positive operating cash flows if elective surgical procedures continue to be deferred."***

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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