BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Macy's (M) Update
Maintain BUY

Macy's provided some positive insight into the economy reopening, its current sales, and its financial position. **We are maintaining our BUY recommendation.** The company has suspended the dividend after the April 1 payment, which will save the company $350 million in cash for the rest of 2020. The capital spending budget will also be cut to about $450 million from the $1 billion forecasted saving another $550 million.

- Liquidity appears ample. Macy's cash was $1.5 billion on May 2. Net of debt, cash was only down $150 million y/y even after the stores being closed for approximately 6-weeks and that includes paying the April dividend of $117 million.

- Macy's is issuing $1.3 billion in secured debt backed by real estate due in 2025. This debt along with $200 million in cash will retire the company's current credit line of $1.5 billion. It is also closing a new asset-backed credit facility of up to $3 billion that will mature in 2024.

- With current liquidity and this new financing, Macy's expects to cover all its short-term liquidity needs, investment in the business via capital spending, and it expects to retire $1 billion in debt over two years.

- Sales are coming in ahead of forecasts as stores reopen. Expectations were for stores to open with sales down 80%-85%. Instead, sales started down 50%. Each week has seen open stores improving by 3%-5% too. Macy's expects to see sales return to normal levels in 2021. Also, competitors closing stores throws about $10 billion in sales up for grabs that Macy's hopes to partially capture.

- Omni channel of sales is working as intended. Digital sales are up 80% in stores that have reopened. Buying online for pickup at the stores is now 9% of digital sales. Macy's continues strong sales from Vendor Direct, which reduces its inventory investment while expanding offerings. Macy's continues to see strong sales in all areas except women's ready-to-wear apparel.

- Store closings will lead to a sizeable hit to sales in 1Q of about $2.5 billion. Macy's expects an operating income loss in the quarter of $900-$1.1 billion. Within that will be an inventory write-down of $300 million largely for seasonal inventory that wasn't sold while stores were closed. Nonseasonal inventory is not expected to cause many charges. This loss will also come from a slowdown in credit revenue and higher bad debt expenses. There are likely to be some impairments on intangible assets too in the 1Q results.

- Gross margin is expected to be down y/y in 2Q as margins deleverage on lower sales. Most stores did not open until after 2Q began on May 3 and the sales are still building back. Management sees gross margin rising in 3Q an 4Q.

- Macy's will continue its focus on loyalty programs and personalization of sales. The emphasis will be on higher ROI investments largely in digital as well.

- The return of the dividend will likely follow the stabilization of results and some debt reduction.

A.P. Moller-Maersk (AMKBY)- EQ Review

Current EQ Rating*	Previous EQ Rating
4+	na

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

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

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

We are initiating earnings quality coverage of AMKBY (the ADR in the US) with a 4+ rating indicating Acceptable and Improving.

Maersk also trades in Copenhagen in Danish Krone as two classes of stock (MAERSK-A with two votes per share) and MAERSK-B that is non-voting. While the company does much of its business and reporting in USD, the shares trade in DKK. In recent years, the currency has been 5.5-6.0 DKK to the dollar, it is currently between 6.5-7.0 DKK to the dollar – so there the potential for about 15% return or loss simply from the exchange rate changing by 1.0 DKK to the dollar.

We thought this would be an interesting name for readers because it has faced many headwinds regarding fuel prices and levels of world trade. The company has gone through a multi-year restructuring to eliminate cyclical commodity-related businesses related to oil exploration, oil transport and dry shipping containers. What is left is a company with a huge footprint in the world container ship market that would be difficult to replicate. It also has improved its door to door model by bulking up relationships with terminals, intermodal and air shipping and warehousing, and well as operating towing vessels in ports.

While we are not going to delve into the COVID and trade issues in-depth for an EQ-report; we do believe the accounting has been conservative. Many areas that would

flag for concerns turned out to be either immaterial to results, low risk going forward, and have good disclosure.

This company still has exposure to fuel prices, the level of world trade on its utilization rates of ships, and the rates it can charge. Even with that volatility, the underlying business is seeing improved profitability and improvements to cash flow and the balance sheet:

- **Joint Venture deals look low risk for Maersk. We do not see evidence that these are being done off-balance sheet to hide leverage or operating costs.** In many cases, they are likely partnering with governments who are not willing to sell the full asset of operating the commercial activities of a port.

- **The Joint Ventures are only about 7% of book value and are part of the more profitable division at Maersk – Terminal operations. The profit and margins are rising.** The risk of having to cover minimum concession payments at these terminals with trade levels down looks minor in terms of dollar exposure vs. the EBITDA and liquidity at Maersk. It also uses a 13% discount rate to determine if impairments are needed which is conservative in our view.

- **Divesting many oil-related businesses improved the balance sheet. Disclosure has been great, gains and losses were run through discontinued operations and removed, and debt/EBITDA has fallen from 4.4x to 2.0x since 2016.**

- **The focus of using divested assets to retire debt and fund shareholder returns as dividends and share repurchases all helped. With this program of asset sales largely complete – the dividend may be paid at the lower part of the company's 30%-50% payout range going forward** – especially with COVID impacting current revenues.

- **The large 2017 acquisition also comes with very few issues for us. They bought a business in their industry where it's easier to achieve some synergies. They didn't overpay at 7.9x EBITDA and have realized significant synergies already to lower that further.**

- **The acquisition accounting was also very conservative. Only 9% of the purchase price went to Goodwill. The other 26% intangibles will be amortized over 15-20 years and Maersk is not adding that back to adjusted earnings. The**

integration and restructuring costs have also been very minor and shown results.

- **Earnings quality is very strong in our view too. For EBITDA, Maersk removes gains/losses and JV income. It also does not add back restructuring charges or dividends received on shares it held as one of the divestments. EBITDA is often below the reported cash from operations.** Plus, this company touts actual cash generated and kept and looks at EBITDA against capital spending too.

- **Income from Continuing Operations adds back gains/losses, impairments, restructuring charges, and transition costs. Most of those are minor. It does not add back amortization of acquired intangibles.**

- The pension assets exceed liabilities and the PBO discount rate is 1.9%.

- Leases have some risk or opportunity as about 12%-15% rolls over in most years. Maersk's revenues are largely variable, but the leases are largely fixed. COVID and trade issues may create the ability to renew leases at favorable or lower rates.

Investments in Joint Arrangements and Associated Companies Have Risks that Appear Very Manageable

Often, this is an area we would expect to see red flags in the form of off-balance sheet leverage and contingencies or an area where a company is keeping expenses off the income statement such as interest expense, R&D, or marketing. We do not see many of those traditional risks in this area for Maersk.

For definition – Joint Arrangements are where Maersk has joint control of the entity above 50%. They are considered Joint Ventures if the investments are separate legal entities and rights are limited to the net assets. They are considered Joint Operations if there are unlimited rights of the owners to the assets and liabilities.

For definition – Associated Companies are entities where Maersk has significant influence through controlling 20%-50% of voting rights but does not have controlling influence.

The list of these companies shows that they are primarily terminals, port operations, and storage operations in places such as China, Hong Kong, Brazil, Bermuda, France, etc. There is some intermodal operations and storage as well. These operations are part of Maersk's efforts to be able to handle shipments beyond just ocean travel and be able to charge higher fees and boost total profits. Much of the terminal and port operations involve loading and unloading ships to and from ground transportation.

There are several reasons we say there the risks appear lower than what we have seen from other companies in this area:

- The size of these deals is a small part of total equity:

	2019	2018	2017
Joint Arrangements	$1,204	$1,333	$1,394
Associated Co's.	$937	$754	$963
Equity	$28,837	$33,380	$31,425
% Book Value	7.4%	6.3%	7.5%

- Liability during COVID-19 could come from minimum volume commitments at some ports where Maersk would need to pay some port authorities to cover times when shipment volumes are lower. That would seem to be a short-term item and not likely to trigger an impairment. However, the variables in assessing future cash flow in this unit are the volume of movements and profit per move. So, volume is likely to be down in 2Q.

- The terminal and towage unit has been earning a margin that exceeds the business as a whole and it has been seeing growth:

Terminal/Towage	1Q20	2019	2018	2018*	2017*
Revenue	$911	$3,894	$3,772	$3,772	$3,481
EBITDA	$276	$1,107	$978	$778	$639
EBITDA %	30.3%	28.4%	26.5%	20.6%	18.4%
Co. EBITDA %	16.3%	15.9%	13.0%	9.8%	11.4%
T&T JV Income	$71	$206	$164	$164	$187*
Co JV Income	$85	$229	$1	$56	$60

2018 and 2017 with * are before the changes in lease accounting

The 2017 JV income added back $265 million of impairments related to lower volumes in several West African ports and difficulty in repatriating some local currencies

Our conclusion on this source of income from associated companies and joint ventures is that the income stream will likely continue although it should be lower in 2Q and perhaps 3Q also. The carrying value of the assets is very low as a percentage of book value as well.

On potential negatives (or sign of conservatism) – Maersk uses a 13% discount rate in evaluating Terminal and Towage assets for impairment. That could trigger an impairment later this year. Also, the minimum volume commitments to some ports could cause a cash payment. For all of 2019, the concession fees at all ports were only $249 million. Volume is not going to be zero and Maersk has $9.2 billion in liquidity.

The Divestitures Improved the Balance Sheet

Maersk had several companies in its portfolio for decades that were highly cyclical – and largely tied to oil prices. The company set out to transform away from that and focus more on its transport business that has some cyclicality to it but for the most part has more inherent growth.

- Conservative Point for Accounting – Maersk immediately classified each unit as Discontinued Operations. Gains and Losses impacted Discontinued Operations.
- Conservative Point for Accounting – Each transaction is broken down into gains/losses, proceeds received, any future proceeds are called out, each is easy to find for impacts on income and cash flow. So, Disclosure is great.
- Conservative Point for Accounting – The Maersk Supply Services which primarily supplies offshore oil drilling activity was unable to be sold in a reasonable amount of time and Maersk moved it back into continuing operations and the carrying value was written down.

What may be the largest material change was the company devoted much of the divestiture proceeds to paying down debt:

Debt Picture	1Q20	2019	2018	2017	2016
Net Interest-Bearing Debt	$12.0	$11.7	$15.0	$15.0	$11.4
EBITDA	$6.0	$5.7	$5.0	$3.5	$2.6
Debt/EBITDA	2.0	2.0	3.0	4.2	4.4
Liquidity	$9.2	$10.5	$10.3	$9.6	$11.8

Net Interest-Bearing Debt = Financed Debt + Leases – Hedging Assets – Cash
Liquidity = Cash on Hand + Undrawn Credit Lines

In 2017, Maersk made a $4.2 billion acquisition that boosted debt.

The list of divestitures:

- The sale of Maersk Oil in 2018 to Total. The company received $4.95 billion in Total stock which they sold over 2018 and 2019. Some of the proceeds from the stock sales were paid as dividends to Maersk shareholders. The deal also included $2.5 billion in cash. The sale generated a $2.6 billion gain – which appeared in income from discontinued operations.

- Maersk has a parent company that holds 51.45% of its A-shares and 41.51% of total shares. That parent bought the Maersk oil tanker business in 2017 for $1.17 billion in cash. That cash went toward debt reduction. It produced a $453 million loss that also appeared in discontinued operations.

- Maersk Drilling was spun off as a dividend to shareholders in 2019. It also took about $1.1 billion in net debt with it. It recognized a $553 million loss on the transaction.

Given that shareholders have received some sizeable dividends in recent years as a result of these divestitures and asset sales and also the dividends received on Total shares – it worth mentioning here that this program is now largely complete.

Maersk intends to pay dividends of 30%-50% of income and currently it expects to be near the lower end of that range. It has been repurchasing shares with excess cash flow, but the dividend has remained flat for 3-years. Last year, it even noted that half the dividend was to be paid from sales of Total stock. Given COVID issues now, we would not count on a dividend increase in 2020.

Acquisitions Also Are Not Creating A Red Flag

Maersk made a sizeable deal in 2017 when it bought Hamburg Sud. That helped consolidate the industry of containership vessels – so it was in their wheelhouse. We also do not think they overpaid. The deal cost $4.4 billion and the stand-alone company had EBITDA of $554 million – so the cost was 7.9x. Also, Maersk forecast synergies of $350-$400 million from the integration and every $100 million achieved, lowers the cost to 6.7x, then 5.8x, then 5.2x. There has been some evidence of margin gain in the Ocean segment as some synergies are unlocked. Maersk claimed it realized $420 million in synergies related to more volume running through terminals operated by Maersk, better schedule optimization, and better procurement.

It is also refreshing to see an acquisition where only 9% of the purchase price was allocated to goodwill. Another 26% was allocated to intangible assets that will be amortized over 15-20 years for brand-names and customer-relationships and 3-5 years for software. The remaining assets went to PP&E which will be depreciated over 12 years for containers and 20-25 years for ships. While EBITDA adds back depreciation and amortization – Maersk is not adjusting for amortization of intangibles and adding that back to adjusted earnings.

Earnings Quality Is Also Strong

Maersk reports two metrics – EBITDA and Income from Continuing Operations. As noted above, we are already impressed that it does not add back the amortization cost from an acquisition, and it expenses the bulk of the purchase price as either amortization or depreciation. We are also impressed that the company also talks about capital spending both for growth and replacement levels and how much of EBITDA it actually retains.

Maersk continually sells older equipment too and minor assets that generate small gains/losses as part of normal operations. These are removed from both EBITDA and Income from Continuing Operations:

EBITDA Calc.	1Q20	1Q19	2019	2018
EBIT	$552	$230	$1,725	$409
Add D&A	$1,073	$1,082	$4,287	$4,756
Less Gains	$19	$18	$71	$166
Less JV Income	$37	$24	$93	$116
Less Ass Co. Income	$48	$34	$136	-$115
EBITDA	$1,521	$1,236	$5,712	$4,998
Cash from Ops	$1,216	$1,482	$5,919	$4,492
Capital Spend	$310	$778	$2,035	$3,219

EBITDA is subtracting the gains on minor asset sales. It is also subtracting all the income from joint ventures and associated companies. Within depreciation, impairments are added back but none of the company's restructuring charges are being added back. The company is not even adding in the cash income from the Total dividends that was received. That is netted against financing charges and would not be part of EBIT.

Most companies we follow, would not adjust EBITDA to remove JV income or ignore dividend income and would certainly add back restructuring charges. The net result is EBITDA is arguably understated at Maersk. It is also higher quality because compared to Cash from Operations, CFO is often larger than EBITDA or at worst – very close to it.

In terms of capital spending, the company gives guidance over a 2-year period and expects to spend $3.0-$4.0 billion between 2020 and 2021. Some of that is growth with replacement spending on older assets estimated at $1.0 billion per year. So, the conclusion is EBITDA is high quality, a good proxy for cash flow, and the company's free cash flow is very strong for shareholders (or for enduring the COVID issues) considering debt/EBITDA is only 2.0x now.

For Income from Continuing Operations, Maersk does not omit the income from JVs and associated companies. It removes gains and adds back impairments like the EBITDA calculation. It also adds back restructuring:

Income Cont. Ops	1Q20	1Q19	2019	2018
Reported	$209	-$104	$509	-$755
Less Gains	$19	$18	$71	$166
add Impairments	$7	$21	$29	$757
add transition costs	$0	$31	$78	$78
add tax adj.	$0	$1	$1	$25
Adj. Income	$197	-$69	$546	-$61

Obviously, depreciation is a sizeable expense item as seen in the EBITDA table. The $757 million impairment in 2018 was largely the result of moving the Maersk Supply Service business back from discontinued operations to continuing in 2018 when the company decided it was not getting it sold in the near future. 2018 impairments also arose from closing container factories in China and Chile of $206 million and another business line for dealing with onerous contracts for tug vessels for $190 million. In total, we think Maersk is reserved for this type of issue at this point. It has an accrual of $1.0 billion for legal disputes and onerous contracts. Those issues may be getting smaller at this point as contracts expire and some of that reserve may be reversed back to income going forward.

We would point out that transition/restructuring charges are actually fairly low following a $4.4 billion acquisition at only $78 million for two years. It is also worth noting that income in 2018 benefitted by the dividends on Total stock of $239 million offsetting financing costs.

Pensions, Debt, Leases

In the case of pensions – we see more conservatism. Maersk is overfunded on its pensions in total and is calculating the obligation with a 1.9% discount rate.

We addressed debt above, even adding the leases in as debt – Net Debt to EBITDA is 2.0x. Maturities are between $0.6-$1.0 billion for bonds and bank debt per year through 2023. The company has $9.2 billion in cash and liquidity.

Leases are largely related to the fleet. It has 307 vessels that it owns and 401 on lease. In general, many of the containership leases are multi-year in duration. In the last several years, the charter rates have been weaker than levels seen prior to

2008. This has been a combination of a growing supply of containerships with slow economic growth from 2009-16 around the world. Then there has been increased concerns on tariffs and now COVID. The result has been a game of chicken between the operating companies and the landlords of these ships. Maersk wants to lock in longer-term leases at the lower charter rates. The landlords want to book shorter-term leases when rates are lower or get some degree of higher rates if the new lease is set for a longer-term. Often, the lease is a flat rate regardless of what Maersk earns by operating the ship. So, if freight rates rise, it's a windfall for Maersk. If they weaken, the landlord still gets paid a fixed lease.

About 12%-15% of leases roll over each year, in the current market there may be a chance to roll over some leases for a longer-term at favorable rates and help Maersk's earnings. Eventually, if demand strengthens for more trade – the rates could rise and that could become a headwind for Maersk. There are also scrubbers that are being added to some of the existing fleet – so they can burn historically cheaper high-sulfur fuel. While those investments are added, some of the fleet is idle and that helps the landlord push for higher lease rates too.

We just want to point out that many of the high-cost leases from 10+ years ago are now gone and the current market has seen more weak years than strong ones for leases rates. There are many variables, but it is possible Maersk sees higher lease costs over time than falling lease costs.

Ritchie Brother Auctioneers (RBA) EQ Review

Current EQ Rating*	Previous EQ Rating
4+	na

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

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

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

We initiate earnings quality coverage of RBA with a 4+ (Acceptable) rating

Overall, while we are somewhat concerned about the degree to which growth is dependent on rising fees which will see some tailwinds expire after the June quarter, we consider RBA's earnings quality to be solid.

- While the gross transaction volume (GTV) generated by RBA's auctions has been growing in the low single-digit range, the company has seen a boost to profit growth from charging higher fees. Some of the increase in fees has been the result of the company's 2017 acquisition of IronPlanet which led to different buyer fees across geographic markets. To remove the incentive to trade in one market over another. The last set of fee changes occurred in June of 2019 so that benefit to year-over-year growth will be gone after the current quarter. Fee growth has also benefitted from an increase in the portion of lower-sized lots which carry higher buyer's fees relative to transaction volume. While this is not an earnings quality issue, we view this as a low-quality source of growth investors should be considering.

- RBA utilizes the declining balance method to depreciate a significant portion of its asset base. This method results in significantly more depreciation being recognized in the early years of an asset's life compared to the more common straight-line method and has contributed to the company reporting depreciation expense more than twice that of capex. Overall, this implies more

conservative earnings. However, we do note that capital spending has fallen to about 1.1% of sales from 1.4% a year ago and the company has cut capital spending for 2020 in light of the current crisis. If the company has to increase capex in future periods to "catch up", it could result in a quick jump in depreciation expense compared to companies that use the straight-line method. We also note that the computer software and leasehold improvement categories (which are depreciated on the straight-line method) are over 80% depreciated which could indicate a need to accelerate spending in those areas.

- RBA did not disclose allowance for bad debts on a quarterly basis prior to the 3/20 quarter. In addition, it did not break out trade receivables from consumption tax receivables making an analysis of receivables and allowance trends difficult. We are able to see that the allowance balance fell from $5.2 million in the 12/19 quarter to $3.7 million in the 3/20 quarter and the company wrote off $1.5 million more in receivables in the quarter than it expensed back to the allowance. These two factors could indicate the company is somewhat under reserved despite its claim that it is not seeing a negative impact on receivables from COVID-19. We do not see this as a huge problem given receivables are largely secured by the equipment sold. However, changes in the reserve have the potential to move EPS 1-2 cps in a quarter. The new disclosure is an improvement although we would prefer to see a breakout of the receivables quarterly given the material consumption tax receivable component.

- Lower stock-based compensation added about 1.5 cps to earnings in the quarter.

- To RBA's credit, the company utilizes very minimal non-GAAP adjustments when presenting earnings. In fact, the 3/20 quarter and its year-ago comparable period did not feature any adjustments. The downside to this is that analysts must be aware of any unusual items impacting comparisons. In the case of the 3/20 quarter, the effective tax rate fell to 19.6% from 26.8% in the year-ago period due to a lower impact from US tax reform and a larger percentage of income taxed in lower-rate jurisdictions. Also, the quarter benefitted from the receipt of $1.7 million (1.5 cps) in contingent consideration from the sale of assets in 2019. Offsetting this was $2 million in nonrecurring depreciation and amortization and other expenses related to the termination

of a UK business arrangement, the cancellation of a property transaction, and executive departures.

- RBA offers some contracts that guarantee a minimum amount of proceeds to sellers. In some cases, it also buys equipment from customers for inventory sales. Both of these "at risk" contract types expose the company to losses if auction proceeds fall below the company's cost. The mix of these contracts is volatile from period to period. At risk contracts rose to 20% of sales in 2019 from 17% the year before but fell to 15% in the 3/20 quarter from 16.5% a year-ago quarter. We see no increased dependence on these contracts for growth, the company's contract with the US Defense Logistics Agency does require it to purchase at least $11 million of surplus government inventory over the next year and RBA has little say in the equipment purchased. However, the company is set up well to sell these items through its GovPlanet business unit and we see the risk of a material loss as low.

Company Overview

RBA operates a leading network of live and online auctions that primarily focus on used and unused heavy equipment such as earthmoving equipment, trailers, governments surplus, and oil and gas machinery. In addition to conducting the auction, RBA inspects and appraises the equipment as well as offering full asset management services to customers. Customers include equipment dealers, construction firms, rental companies, and OEMs. RBA has over 40 permanent auction locations in 12 countries but has migrated much of its business online. Its 2017 acquisition of Iron Planet boosted its online equipment auction reach. Roughly 80% of the company's gross transaction volume (GTV) is generated at live auction sites with online auction sites generating the balance. However, buyers can submit bids to the on-site auctions from online and over 50% of winning bids now come from online. This has not diminished the importance of the on-site locations as many sellers still look to the company to move equipment to its sites to perform the appraisal and preparation services.

RBA earns a commission from the seller based on the auction proceeds as well as various fees from the buyer and seller as well as revenue from ancillary services such as asset management. The company also does guarantee contracts where the

consignor is guaranteed a minimum amount plus additional amounts if proceeds exceed an agreed-upon level. Also, the company can purchase equipment from consignors. In such “inventory sales” RBA books the revenue and records a corresponding cost of inventory sales. Inventory sales as a percentage of total revenue is quite volatile but typically runs in the 30-40% range. Given the substantially lower margins on these deals, the mix of inventory sales significantly distorts the traditional total firmwide gross profit measure. Also note that prior to the 2018 adoption of ASC 606, RBA recorded inventory sales on a net basis in revenues with nothing reflected in cost of sales. Thus, analysts must be certain that historical data has been restated to reflect the accounting change.

Much of the Recent Growth Is Coming from Fee Increases

RBA’s total revenue growth can be a misleading figure given the volatility in inventory sales from period to period. GTV gives a better idea of the growth in auction activity as it measures as it captures the total volume of lots sold through the company’s auction platforms. Table 1 shows the growth in GTV for the last five years.

Table 1

	2019	2018	2017	2016	2015
Service GTV	$4,626	$4,544	$4,121	na	na
growth	*1.8%*	*10.3%*			
Inventory GTV	$515	$421	$347	na	na
growth	*22.4%*	*21.3%*			
Total GTV	$5,141	$4,964	$4,468	$4,335	$4,248
growth	*3.6%*	*11.1%*	*3.1%*	*2.1%*	

The spike in GTV growth in 2018 was driven by the 5/31/2017 acquisition of IronPlanet, a major online heavy equipment auction house. Absent that temporary boost, total GTV has been growing in the 2-3% range. However, much of the total GTV growth has been driven by a huge jump in inventory GTV while growth in the more important service GTV fell to under 2% in 2019. Table 2 shows the same measures on a quarterly basis for the last two years:

Table 2

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Service GTV	$1,056.893	$1,270.183	$973.022	$1,339.141
	1.3%	7.7%	1.8%	0.5%
Inventory GTV	$90.132	$113.725	$111.219	$158.616
	-31.2%	-28.1%	32.4%	68.4%
Total GTV	$1,147.025	$1,383.908	$1,084.241	$1,497.757
	-2.4%	3.5%	4.3%	5.0%

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Service GTV	$1,043.624	$1,179.421	$955.455	$1,332.228
Inventory GTV	$131.057	$158.193	$83.972	$94.184
Total GTV	$1,174.681	$1,337.614	$1,039.427	$1,426.412

Growth in GTV can be volatile based on the timing of auctions and equipment coming available. However, the company has been able to generate gross profit growth in excess of GTV growth in part due to growing fee revenue. This can be seen in the following table which shows the components of service revenue, inventory sales revenue, and total company gross profit for the last

Table 3

	2019	2018	2017	2016
Total GTV	$5,141	$4,964	$4,468	$4,335
Commissions	$432	$420	$394	$366
Fees	$372	$329	$230	$190
Total Service Revenue	$804	$750	$624	$556
Cost of Service Revenue	$165	$159	$133	$113
Service Gross Margin	$639	$590	$491	$443
Inventory Sales Revenue	$515	$421	$347	$571
Cost of Inventory Sales	$481	$374	$306	$513
Gross Inventory Profits	$34	$46	$40	$58
Total Gross Profit	$673	$637	$532	$500
Increase in:				
Commissions	$12	$26	$28	
Fees	$43	$99	$41	
Total Service Revenue	$55	$125	$69	
Total Gross Profit	$36	$105	$31	

Table 3 shows that the growth in fee revenue accounted for roughly 80% of the growth in service revenue in each of the last two years despite accounting for less than half of total service revenue. We also think it is informative to look at total gross profit rather than revenue as it helps to adjust for the mix of inventory sales. Not all fee revenue is purely based on GTV so it does not all pure profit. Still, incremental fee revenue is likely very profitable. As such, it is interesting to note that the absolute dollar growth in fee revenue has exceeded the growth in gross profit for the last three years.

The outsized growth in fee revenue can also be seen by looking at it as a percentage of service GTV:

Table 4

	2019	2018	2017
Service GTV	$4,626	$4,544	$4,121
Commissions	$432	$420	$394
% of Service GTV	9.3%	9.2%	9.6%
Fees	$372	$329	$230
% of Service GTV	8.0%	7.2%	5.6%

We see that commissions as a percentage of service GTV has remained fairly consistent over the last three years while fees as a percentage of service GTV have risen from 5.6% to 8.0%. The company attributed the jump in fee revenue in 2019 to higher total GTV, full buyer fee harmonization implemented in June 2019, and RBFS fee revenue growth… partially offset by lower RB Logistics revenue earned in the International region." Buyer fee harmonization is related to the 2017 acquisition of IronPlanet, which had different buyer fees that the company in various geographic markets. In 2018, RBA implemented changes to buyers fees to move them more towards parity across markets. A second round of fee changes was implemented in June of 2019 which resulted in an increase in average rates. This benefit will expire after the second quarter. We are in the process of obtaining historical rate data to allow us to quantify how much rate harmonization has boosted results.

The company also noted in the 3/20 10-Q that fee growth was boosted by a greater proportion of small lots. The company's website lists the current buyer fee schedule:

Successful bidders are required to pay a transaction fee:

- *Each purchased lot will be subject to a transaction fee of:* ***(a) 10% on all lots selling for 10,000 or less, (b) 3.85% on all lots selling for more than 10,000 up to 33,500, with a minimum fee of 1,000 per lot or, (c) 1,290 on all lots selling for over 33,500 (in the currency of the auction).*** *The transaction fee applies to on-site, online and proxy purchases and will be waived for purchases made in person at on-the-farm auctions.*

- *The following exceptions will apply to the foregoing. Each purchased lot will be subject to a transaction fee of:*
  - *Japan – (a) 10% on all Lots selling for JPY 1,000,000 or less, or (b) 3.85% on all Lots selling for over JPY 1,000,000 up to JPY 3,400,000, with a minimum fee of JPY 100,000 per lot, or (c) JPY 130,000 on all Lots selling for over JPY 3,400,000;*
  - *United Kingdom - (a) 10% on all Lots selling for GBP 5,000 or less or (b) 3.85% on all Lots selling for over GBP 5,000, with a minimum fee of GBP 500 per Lot*

We see that lots less that $10,000 draw a 10% buyers fee while the effective percentage gradually falls to 3.85% on lot sizes above $10,000. Average lot sizes have been declining for several quarters which helps to boost the growth in fee revenue as

a percentage of GTV. Not all of this flows to profits as the higher fees are designed to compensate for the fact that a $5,000 trailer may take as much time to handle, store and process as a $50,000 bulldozer. While it may be true that the increase in fees driven by smaller lots may not all fall to the bottom line, we still suspect that the impact on profit growth is greater than the impact on GTV from the related transaction.

Fee growth is also being drive by the company driving higher use of services such as financing transactions, logistics services, and asset management services. These are helping to drive revenue growth above the low single-digit growth in service GTV. While these are legitimate sources of growth, the one-time fee harmonization and the temporary benefit from smaller lot sizes to be lower quality.

Accelerated Depreciation

RBA utilizes the declining balance method to depreciate much of its fixed asset base. The following table shows the deprecation method for each asset class along with the percentage of the gross balance that has been depreciated:

Table 5

	Dep. Method	Gross	Acc. Dep.	Net	% Depr.
Land and Improvements	Declining Balance- 10%	$361.623	-$77.015	$284.608	21%
Buildings	Straight Line- 15-30 yrs	$252.774	-$115.423	$137.351	46%
Yard and Automotive Equipment	Declining Balance- 20-30%	$66.871	-$40.686	$26.185	61%
Computer Software and Equipment	Straight Line- 3-5 yrs	$80.756	-$68.431	$12.325	85%
Office Equipment	Declining Balance- 20%	$31.760	-$21.776	$9.984	69%
Leasehold Improvements	Straight Line	$19.756	-$16.541	$3.215	84%
Assets Under Development		$10.814		$10.814	0%
		$824.354	-$339.872	$484.482	41%

Most companies utilize the straight-line method to depreciate assets where the depreciation for the asset each year is the gross balance divided by the estimated number of years of service. Since it is calculated on the gross balance, the periodic depreciation for the asset is the same every period. Under the declining balance method, the beginning net book value is multiplied by a percentage each period which results in depreciation expense declining rapidly throughout the life of the asset. This is a more realistic method for assets that have more utility early in their life cycle or in cases where the assets will require significant maintenance spending as they age.

These would seem to apply to office equipment and yard equipment although this does not make as much sense to us for land and improvements.

To examine the difference in expense recognition under the two methods, let's look at the difference in depreciation on a $10,000 piece of office equipment with a residual value of $0 using RBA's policy of the declining balance with a 20% rate versus using the straight-line method over a typical period of ten years. The following table shows annual depreciation expense and the ending net book value for each method:

Straight Line- 10 years	Depreciation Expense	Ending Net
Year 1	$1,000	$9,000
Year 2	$1,000	$8,000
Year 3	$1,000	$7,000
Year 4	$1,000	$6,000
Year 5	$1,000	$5,000
Year 6	$1,000	$4,000
Year 7	$1,000	$3,000
Year 8	$1,000	$2,000
Year 9	$1,000	$1,000
Year 10	$1,000	$0

Declining Balance- 20%	Depreciation Expense	Ending Net
Year 1	$2,000	$8,000
Year 2	$1,600	$6,400
Year 3	$1,280	$5,120
Year 4	$1,024	$4,096
Year 5	$819	$3,277
Year 6	$655	$2,621
Year 7	$524	$2,097
Year 8	$419	$1,678
Year 9	$336	$1,342
Year 10	$268	$1,074

We see that RBA's declining balance method results in substantially higher depreciation expense in the early years which drops off dramatically by year ten. Note that while there is still a net book value under the declining balance method at the end of year ten, this would likely be below a reasonable residual value in the real world.

This accelerated recognition of depreciation is a contributing factor in RBA booking depreciation more than double that of capex which is shown in the following table:

	2019	2018	2017
Depreciation Expense	$29.112	$29.021	$28.337
Capital Spending	$13.589	$16.860	$10.812

The high depreciation expense relative to capex implies a stronger earnings quality. However, we also note that capex has declined to 1.1% of sales from 1.4% a year ago and the company has cut its capex spending plans for 2020 in response to the uncertain environment. As the asset base ages, the company may see a boost from lower depreciation expense more quickly than it would if it used the straight-line method for all asset classes. However, this will work in reverse if the company must ramp up spending after the crisis clears.

We would also note that Table 4 shows that purchased computer software and equipment and leasehold improvements (both depreciated under the straight-line method) are more than 80% depreciated as of the end of the year. This could be an indication that these assets are running out of useful life which will necessitate an acceleration in cash spending in that area. This is particularly true for computer equipment given the company's increasing reliance on technology for its on-line auction platforms. It is also worth noting that the company capitalizes internally developed software as a component of intangible assets (rather than PP&E) and amortizes those costs over 3-5 years which seems reasonable.

Receivables Allowance Disclosure Is Weak

RBA discloses "trade and other receivables" on its quarterly balance sheets. On an annual basis, it breaks that account down which shows that the account includes a sizable consumption tax receivable component:

	2019	2018	2017
Trade Receivables	$121.752	$112.680	$77.870
Consumption Tax Receivable	$12.108	$16.099	$13.592
Other Receivables	$3.542	$0.478	$0.643
Total Trade and Other Receivables	$137.402	$129.257	$92.105

Until the 3/20 quarter, RBA did not disclose the allowance for bad debts in its quarterly filings. Given that there is likely little of the allowance related to the consumption tax or other receivables portion of the balance, the most informative way to analyze the credit allowance is to compare it to only the trade receivables portion of the account:

	2019	2018	2017
Trade Receivables	$121.752	$112.680	$77.870
Allowance for Losses	$5.225	$5.942	$5.443
Allowance % of Gross Receivables	4.1%	5.0%	6.5%

We can see that the allowance percentage has fallen significantly in the last three years. Given that we don't know the components of the "trade and other receivables" account disclosed in the 3/20 10-Q, we can't calculate a comparable ratio for that quarter. However, we can look at the sequential trend in the allowance compared to the movement of the annual "trade and other receivable accounts" for the last three fiscal years:

	3/20	3/19	2019	2018	2017
Trade and Other Receivables	$245.727	$220.452	$137.402	$129.257	$92.105
Allowance	$3.727	na	$5.225	$5.942	$5.443
Allowance % of Gross Receivables	1.5%	na	3.7%	4.4%	5.6%

We suspect the jump in receivables and the fall in the allowance percentage from the 12/19 to the 3/20 quarter is related to the timing of consumption tax receipts which do not have an allowance associated with them. The company stated in the 10-Q that it has not seen a decline in receivables quality due to COVID-19. Regardless, the sequential decline in the allowance itself seems unusual and could be an indication that the allowance percentage was reduced. This is further indicated by the company's new disclosure as of the 3/20 10-Q which shows the movement in the allowance:

Allowance for Credit Losses	
Opening Balance 1/1/20	$5.2250
Current Period Provision	$0.6580
Write-off charged against allowance	-$2.1560
Balance 3/31/20	$3.7270

Despite more than $2 million in receivable write-offs, the company only incurred $658,000 in expense to replenish the reserve.

As the discussion above indicates, the company's receivable disclosures prior to the 3/20 quarter make it very difficult to get a clear picture of what is happening with receivables. The new disclosure in the 10-Q will give a clearer picture after a year passes and we can do YOY comparisons by quarter. It would be even better if the company provided a breakdown of receivables by quarter given the large and apparently volatile impact of consumption tax receivables. Overall, we do not have a large degree of concern related to receivables given they are largely secured by the equipment being sold. However, we note that a $2 million move in the provision expense could move EPS in any quarter by roughly 1.5 cps.

Other Items

To RBA's credit, the company utilizes very minimal non-GAAP adjustments when presenting earnings. In fact, the 3/20 quarter and its year-ago comparable period did not feature any adjustments. The downside to this is that analysts must be aware of any unusual items impacting comparisons. In the case of the 3/20 quarter, the effective tax rate fell to 19.6% from 26.8% in the year-ago period due to a lower impact from US tax reform and a larger percentage of income taxed in lower-rate jurisdictions. In addition, the quarter benefitted from the receipt of $1.7 million (1.5 cps) in contingent consideration from the sale of assets in 2019. Offsetting this was $2 million in nonrecurring depreciation and amortization and other expenses related to the termination of a UK business arrangement, the cancellation of a property transaction, and executive departures.

Guarantee and Inventory Contracts Carry Higher Risk

As we discussed above, some of the company's contracts involve RBA either buying the asset from the seller in an inventory sale, or guaranteeing a minimum amount of auction proceeds to the seller. These are referred to as "at risk" contracts given the company's exposure to a potential loss should the final auction price fall below the company's costs. The proportion of at risk contracts can vary significantly from period to period. At risk contracts jumped to 20% of total revenue in 2019 versus 17% in the previous year. However, at risk contracts fell to 15% in the 3/20 quarter from 16.5% a year-ago quarter.

While there is not an increasing reliance on at-risk contracts for growth, it is worth noting that in December of 2017, the company entered into a two-year contract with the US Government Defense Logistics Agency to acquire and sell non-rolling stock surplus assets. These contracts required RBA to purchase between $11 million and $51 million of property annually between 4/18 and 3/20. As of 3/31/20, the company had purchased $41 million of property. RBA elected to extend the contract another year to 3/21. Adding to the risk is the fact that the RBA has little control over the types of assets it may be required to buy, and much of the items purchased may not be equipment the company typically sells. However, the company is able to sell the product through its GovPlanet unit which specializes in government surplus and the company's election to reup the contract indicates success so far. If RBA chooses, it can limit its purchases to $11 million over the next year which would limit its loss exposure to a reasonable degree. As such, we do not see this as a material overhang.

Explanation of EQ Rating Scale

Rating	Explanation
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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