BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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www.btnresearch.com

Contents

General Dynamics (GD) 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 GD with a 4- rating (Acceptable)

General Dynamics (GD) appears to be to in good shape to survive the COVID issues. That has primarily impacted its Gulfstream aircraft unit which is 25% of sales. Gulfstream books revenue when planes are delivered to the customer and the company noted in 1Q20, it has not suffered from lack of demand – instead, customers were delayed in travel to come pick up the new plane. They couldn't deliver 13 planes in 1Q – but the customers still want them. The company cut its forecast for deliveries of 150 to 125-130. That seems to be the primary negative impact of the lockdowns. It looks to be more of a timing issue than lost business.

Liquidity appears more than adequate in our view. GD had $2.0 billion in notes coming due in May 2020. It issued $4.0 billion in new notes and added over $2 billion on commercial paper. Cash rose to $5.3 billion from $0.9 billion despite posting negative cash flow in the quarter and paying the dividend and buying some stock. At this point, it has put stock repurchases on hold after spending $449 million in 1Q – but often is well over $1 billion per year, which will further preserve liquidity.

An area where GD could see some further improvements in liquidity and/or cash flow is coming from the government accelerating payments to the defense contractors. As noted on the call:

> "*The Department of Defense is accelerating payment to us to support the defense industrial base. We believe that this will prove to be very helpful.*"
>
> ***we've seen accelerated payments coming from some of our customers starting in the month of April in the form of increased progress payment rates*** *and other contract mechanism, but we've passed those monies on to our suppliers to help sustain our supply base. In fact, as of last week, we had received approximately $55 million in accelerated payments from our customers and advanced almost $300 million to our suppliers on an accelerated basis."*

The government also is moving faster on Request for Proposal and has boosted deposits and payment rates of 80% on progress payments to 90%. We think GD could see cash flow increase from these faster payments and falling receivables. **In the short-term, it will invest some of that into faster payments to its suppliers and payables will also decline. Then in the 2H of the year, payables may grow again and release cash back to GD.** This likely will be more pronounced in 2Q results, but for 1Q, payables fell $374 million and A/R were only up $84 million.

- **We have some concerns about GD's ROI declining. It fell to 14.0% in 2019 from 15.4% and 16.8% in 2018 and 2017.** Some of that is due to adding underfunded pension liabilities to the debt figure in capital. We give GD kudos for actually treating that as debt, which is part of the drag effect on ROI.

- **The drop in tax rate from 35% to 21% for 2018 added 200bp to ROI and it is still falling. Also, the heavy stock repurchases reduced the capital figure and likely added another 100bp to ROI. Now stock purchases are on hold.**

- **Going back 10-12 years, ROI was 17%-18% against the current 14%. Those older ROIs came with a 35% tax rate and GD was spending more on R&D at that time too with fewer R&D tax credits. Adjusting for apples-to-apples – ROI is down 500-600bp.**

- **GD's purchase of CSRA in early 2018 raises some other questions too. The depreciation and amortization periods look longer than CSRA's assumptions. GD forecast 200bp of synergies over total company sales from the deal by 2020. Margins are actually down** for the full firm two years later and in the I.T. unit dollar income is down, and margins have only gained a few basis points. Also, it's an I.T. company – how can R&D be declining in percentage and dollar terms? **R&D may be at least 40bp too low compared to historical levels as a percentage of sales – that is adding about 44-cents to EPS.**

- **CSRA resulted in sizeable goodwill and it is tested for impairment. GD said after 2018, fair value exceeded carrying value by 5%, after 2019 it said fair value exceeds carrying value by 25%. Yet, results didn't materially improve, and it warns that the impairment test may rely heavily on synergies being achieved.** Also, 30%-40% of CSRA's cash flow came from selling receivables, and GD stopped that program. It seems possible that CSRA's cash flow is lower now.

- **The pension problems may bottom out in 2020 and start to improve. In 2020, pension expense was $107 million. We believe it could fall to essentially $0. A $100 million swing adds about 27-cents to EPS.**

- **The lower discount rate used to value obligations added over $2 billion to PBO last year, rates are down again in 2020, but to the same extent.** GD may only see PBO increase about $600 million under the current situation. However, the lower rate will also decrease interest expense in the cost calculation.

- **The pension asset total is higher, and GD is adding $470 million to the pension plan in 2020. The expected rate of return estimate will boost the income part of pension cost too and should help lower last year's $107 million net expense figure.**

- **Further helping cash flow and perhaps leading to higher pension funding is the acceleration of government payments described above. GD can bill the government for pension costs that exceeded prior forecasts. However, the government tends to all this on a longer-term time horizon. GD has $144 million in deferred costs for this that plans to bill and may get that chance in 2020.** Also, if GD is not buying back shares at this time, it could apply cash flow to higher pension funding which would effectively reduce debt and let them compute a return on assets of 7.46% that boosts net income.

- **Unbilled receivables have been an annual $1 billion drag on cash flow for the last three years. Much of that is due to a single contract that now has a new payment structure and GD collected $0.5 billion in 1Q and should receive another $0.5 billion in 2Q. Also, if the government is accelerating payments and boosting the percentage on progress payments – that may allow more of these unbilled receivables to convert to billed and then collected and become a cash generator in 2020**.

How Strong is GD's ROI?

GD has always touted its ROI figures and EPS growth. The formula used is basically fine. GD adds back interest expense net of taxes and amortization net of taxes to net income. It divides that by average capital which is underfunded pension liabilities plus debt and equity. In general, we have a problem adding back amortization and not expensing goodwill because it makes acquisitions appear to have zero cost. Here are the last three years of ROIC:

	2019	2018	2017
Earnings Cont. Ops	$3,484	$3,358	$2,912
after-tax Int. Exp.	$373	$295	$76
after-tax Amort.	$287	$258	$51
Net Op. Income	$4,144	$3,911	$3,039
Avg. Capital	$29,620	$25,367	$18,099
ROIC	14.0%	15.4%	16.8%
ROIC with Amort.	13.0%	14.4%	16.5%

Returns are still strong but are generally falling. Here are some additional red flags from that:

- The tax rate fell for GD in 2018 by 14 points. Shouldn't that alone be boosting ROI? We estimate that without the tax cut, ROI in 2019 would have been 12.0% and 13.1% in 2018.
- GD also benefited from higher R&D tax credits in recent years. Tax credits lowered the effective tax rate by 80bp in 2017, 110bp in 2018, and 200bp in 2019. Without this, the ROI drops another 0.3% in 2019.
- GD saw higher income because it spent less on R&D overall too. It fell in dollar terms and as a percentage of sales from 1.7% to 1.2%. That's AFTER acquiring an IT company. GD attributes this to completing work on test programs for G500 and G600 aircraft. It also notes that there are cost-sharing deals with suppliers that offset R&D. We're still going to point this out as an expense that may increase in the future. If this had stayed at 1.7% of sales in 2019, income would have been $160 million lower and cut ROI by another 0.5%.
- GD buys back a great deal of stock. They can afford it and shareholders have grown to expect it. We're only going to call this a red flag in that it lowers the equity balance and thus the denominator in calculating the ROI:

	2019	2018	2017
Cash from Ops	$2,981	$3,148	$3,876
CapX	$987	$690	$428
Free Cash Flow	$1,994	$2,458	$3,448
Dividends Paid	$1,152	$1,075	$986
Stock Repo.	$231	$1,769	$1,558

Share repurchases were slowing and are now on hold for COVID appearances (should a company being paid by the government be buying back stock at this time?) If the share repurchases had not happened, ROI would be about 90-100bp lower with another $2 billion in the denominator. If share repurchases are on hold, this headwind to ROI could materialize. Smaller share repurchases also impact EPS growth:

	2019	2018	2017
EPS growth	6.8%	17.4%	10.6%
EPS growth due to falling share count	3.0%	2.1%	1.9%

Last year, nearly half the EPS growth was due to a lower share count.

It is not that tough to conclude that without tax law changes – which GD had no control over, without stock repurchases that it is suspending at the moment, and holding R&D flat – that ROI may be closer to 10.5% even adding back the amortization (Income from continuing operations of $4144 is lower by $672 from tax issues and $160 from R&D) and Average capital is $2 billion higher at $31.6b compared to 2017's ROI of 16.8%.

Also, keep in mind that GD is supposed to be benefitting from synergies from the CSRA deal amounting to 2% of combined company sales by 2020. That's about $630 million in higher net income and some of that should have been realized in 2019. Yet, ROI is still declining. Even before COVID – 2020 guidance was not that exciting in our view – EPS growth of 4.8%-5.2% on 3% sales growth and 10-20bp margin gain in all operating units.

We should also point out that the underfunded pension plan is driving up the average capital figure too in the ROI calculation. We will give GD kudos for counting this as debt. It is also possible that if discount rates increase – this underfunding level could decline:

Pension Underfunding	2019	2018	2017
Debt	$5,172	$4,422	$4,408
PBO discount rate	3.19%	4.28%	3.62%

Adding pension debt to the ROI calculation is costing GD 270bp of ROI.

Other Accounting Changes Have Impacted ROI over Time

We chose a few years in the past to look at what ROI used to be at GD. Overall, it was higher than now. Here are a few years using GD's calculations:

ROI	2009	2008	2007	2006
Earnings Cont. Ops	$2,407	$2,478	$2,080	$1,710
after-tax int. exp.	$117	$91	$89	$106
after-tax amort.	$149	$100	$99	$90
Net Op Income	$2,673	$2,669	$2,268	$1,906
Avg Capital	$15,003	$14,390	$13,430	$12,220
ROIC	17.8%	18.5%	16.9%	15.6%
ROIC with Amort.	16.8%	17.9%	16.2%	14.9%

Two things that need to be addressed. The first is GD did not include underfunding levels for pensions in debt for the ROI calculation during those years. There is nothing nefarious in that in our view – GD simply had an essentially fully funded or overfunded pension prior to the financial crisis. Here are the pension underfunding levels during those years:

	2009	2008	2007	2006
Pension Underfunding	$2,813	$3,063	$499	$386

Looking apples to apples – this would add $2.9 billion to the Avg Capital in 2009 and $1.8 billion in 2008. That adjustment would make ROI 14.9% in 2009 and 16.5% in 2008. That is still handily beating recent years.

The second change to address is 2006-09 used a 35% tax rate. Adjusting for that would boost 2009 income by $492 million and 2008 by $505 million. So, ROI with the pension debt and today's tax rate would be 17.6% in 2009 and 19.6% in 2008. That compares to today's ROI of 14%-15%.

Net, while revenues are about 25% higher now, look at how much more GD was spending on R&D a few years ago. GD used to break this down as company-sponsored and customer sponsored. It sounds like the customer sponsored was contracted to GD and adds to revenue and expenses:

	2009	2008	2007	2006
Company R&D	$520	$474	$430	$377
Customer R&D	$405	$212	$192	$398
Total	$925	$686	$622	$775
Company % Sales	1.6%	1.6%	1.6%	1.6%
Total % Sales	2.9%	2.3%	2.3%	3.2%

In 2019, R&D was only $466 million and 1.2% of sales against a few years ago when 1.6% was common. That 40bp of higher spending hurts ROI in 2009 and 2008 by about 55bp.

Tax credits were also much smaller. In 2019, that lowered the tax rate by 200bp. In 2009, that was only a 70bp item and in 2008 it was only 50bp. We estimate that if GD had 100bp more in this area 10-years ago, it's ROI would have been about 25bp higher.

Goodwill is no longer amortized. It wasn't ten years ago either. It used to be expensed over 40-years. When it's not expensed, that figure is growing:

	2020	2015	2010	2005
Goodwill	$19.7	$11.4	$12.6	$6.7
Equity	$13.2	$10.7	$13.3	$8.1
%	149%	107%	95%	83%

If Goodwill was still being expensed it would be costing GD $490 million per year now it would be a drag on ROI of 170bp.

Our conclusion with just these items is 10-years ago, the adjusted ROI at GD was basically 18-20% using the same tax rate and the same components in debt. The company spent more on R&D in those years and adjusting that would boost the historical ROI another 70-80bp. Apples to apples, ROI is now 500-600bp lower. That is with the tailwind of merger synergies too. In both situations, ROI is gaining 100bp based on adding back all acquisition amortization.

The CSRA Acquisition Adds Earnings Quality Issues

CSRA was the largest deal GD has made. The price was $9.6 billion which was 11.9x EBITDA and 1.9x revenue. At the time if the deal, in early 2018, GD forecast that synergies would be 2% of combined sales by 2020. That is essentially $800 million in higher operating income or $630 million net of taxes.

CSRA did not have enormous operating income to begin with when forecasting $800 million of synergies:

CSRA	9 mths 12/17	9 mths 12/16	12 mths 3/17	12 mths 3/16
Revenue	$3,810	$3,739	$4,993	$4,250
COGS	$3,064	$3,023	$4,027	$3,478
SG&A	$156	$153	$210	$187
Depr/Amort.	$175	$189	$241	$182
Oper Income	$415	$374	$515	$403
Margin	10.9%	10.0%	10.3%	9.5%

- Operating income excludes mark to market items of +$197 in year ended 3/17 and -$98 in year ended 3/16, and loss on sale of HQ building of $10 in nine months 12/16

The purchase price allocation valued CSRA's existing intangibles at much higher levels.

CSRA Bal. Sheet	Post Deal	Before Deal
Goodwill	$7,859	$2,522
Intangibles	$2,066	$926
PP&E	$673	$622
Equity	$9,749	$651

Some of the cost savings may come from changing the expected lives of these assets too. Obviously, neither CSRA nor GD amortized goodwill. However, intangibles are largely customer relationships. CSRA was amortizing those over 20-years. GD amortizes these assets over as long as 30 years. There is a modest amount of software too. CSRA amortized that over 2-7 years, while GD uses 5-20 years. PP&E was being amortized over 3-5 years and other equipment over 5-10 years. Now, GD depreciates that over "up to 30 years."

Is the carrying value of the goodwill sustainable? In 2018, GD said this about goodwill for CRSA:

> ***"The estimated fair value of each of our reporting units was substantially in excess of its respective carrying value as of December 31, 2018, with the exception of our Information Technology reporting unit for which the excess was slightly more than 5%.*** *This is due to the significant size of the CSRA acquisition relative to the newly formed Information Technology reporting unit and its recent acquisition date.* ***Given that the net book value of this business was recorded at its fair value during the current reporting period, the reporting unit's carrying value, by default, closely approximates its fair value*** *at year end. As the carrying value and fair value of the Information Technology reporting unit are closely aligned,* ***a material change in the fair value or carrying value would put the reporting unit at risk of goodwill impairment. For example, our ability to realize synergies*** *from the acquisition of CSRA and the level of funding in the U.S. government budget for contracts in our portfolio are key assumptions in our projections of revenue, earnings and cash flows.*

In 2019, GD said the margin between carrying value and fair market value widened considerably:

> *"As of December 31, 2019, we completed a quantitative assessment for our Information Technology reporting unit, and the results indicated that no impairment existed.* ***The Information Technology reporting unit's estimated fair value exceeded its carrying value by approximately 25%,*** *reflecting the size of the CSRA acquisition relative to the Information Technology reporting unit and its recent acquisition date. Given that the net book value of this business was recorded at its fair value at the acquisition date in 2018, the reporting unit's carrying value, by default, continues to closely approximate its fair value as of December 31, 2019. As the carrying value and fair value of the Information Technology reporting unit are closely aligned, a material change in the fair value or carrying value could put the reporting unit at risk of goodwill impairment****. For example, if the synergies from the acquisition or funding in the U.S. government budget for our contracts fall significantly below our projections, the fair value of the reporting unit would be negatively impacted. Similarly, an increase in interest rates would lower our discounted cash flows and negatively impact the fair value of the reporting unit.****"*

We see two reasons to wonder about this surge in fair market value. First, there are very few signs of actual growth or margin expansion from synergies.

Info Tech	2020e	2019	2018
Revenues	$8,450	$8,472	$8,269
Oper Income	$640	$628	$608
Oper. Margin	7.6%	7.5%	7.4%

2020e is the company's guidance pre-COVID. Also, the bump in 2019 is because they owned CSRA for the full year vs. the partial year in 2018. In 1Q20, the margin improved from 7.2% to 7.5% based on divesting some lower margin units. Actual dollar sales and income declined.

Also, total operating margin for the full company fell 50bp in 2019. Management attributes this having more new contracts than older ones as margins often increase on projects over time. Pre-COVID guidance was calling for margin gain in 2020 of about 10-15bp. The synergy target is calling for 200bp of gains by 2020. Let's also not forget that ROI is declining too.

The second reason is GD unwound CSRA's receivable purchase plan by paying $450 million. By selling more receivables than collected receivables, it was a key source of cash flow for CSRA. It seems reasonable that CSRA's cash flow may be lower now:

CSRA Cash Flow	9 mths 12/17	9 mths 12/16	12 mths 3/17	12 mths 3/16
A/R Sold	$2,262	$2,332	$3,155	$2,497
A/R Collected	$2,127	$2,192	$3,089	$2,324
Cash from Program	$130	$137	$62	$170
Cash from Ops	$316	$438	$488	$278
Program % CFO	41.1%	31.3%	12.7%	61.2%

Our conclusion is GD is far from an aggressive acquisition machine. Paying 11.9x EBITDA is not excessive either. However, we do think there is a risk of a write-down in this area if synergies do not materialize. It does not appear that there is much margin gain at this point nor was it expected this year in original guidance. Potentially extending asset life assumptions may have already helped in 2018.

Pension Issues May Improve After 2020

We think GD's pension issues may bottom out in 2020 – that may make it still worse by year-end, but here is what we see with the underfunding level of $4.9 billion at the end of 2019.

- The PBO jumped by $2.4 billion in 2019 as the discount rate fell by 109bp to 3.19%. Rates have fallen since on high-grade corporate bonds, but the amount of decline has been smaller – in the range of 20-30bp. That may mean PBO rises another $600-$700 million in 2020.
- One-third of the pension assets are in bonds – those should be appreciating in value at this time. The equity positions are described as being fairly diversified, the S&P 500 is down, but at this point, it has recovered the bulk of the COVID selloff.
- GD is also expecting to make a sizeable contribution in 2020 of $470 million, which is almost 10% of the underfunding total at the end of 2019.
- The Department of Defense is accelerating payments to defense contractors as we noted in the liquidity discussion earlier in this report. That is important for the pension plans due to reimbursement under Cost Accounting Standards.

In our reports on Lockheed (LMT) we have discussed how companies with US Government contracts also let them bill the government for employee pension benefits. If the cost of pensions rises above initial forecasts, the companies can recover those higher costs. The rapid decline in interest rates has boosted the PBO for many of the defense companies including GD, which allows them to bill the government for additional costs.

This CAS (Cost Accounting Standards) has three key points:

- The payments from the government flow through as revenues – not directly to the pension plan. The company has to bill for the pension cost overruns on contract work going forward. The company may not fully call them out either.

- The government takes a longer-term view of this issue than FAS (Financial Accounting Standards) so the company often is funding the pension first and collecting from the government over a longer time in arrears. Also, the government believes that over time the rate of return on assets will more closely approximate the discount rate to determine the PBO. Those higher rates are expected to mitigate some of the underfunding and thus the amount GD can bill.
- While GD currently has a $4.9 billion shortfall, the CAS rules may not allow it to submit bills for that full amount. Also, GD needs to have contracts where these higher past costs can be allocated. As GD says in its 10-K – "*For some of these [retirement benefit] plans, the cumulative pension and other post-retirement benefit cost exceeds the amount currently allocable to contracts.*"

GD defers some of its pension costs that cannot be billed yet into an account called "Other Contract Costs" that is part of Current Assets. These costs are recognized when they can bill for the pension costs. So again, GD normally funds the pension first, then bills for the expense, and collects cash through higher revenues on a lagging basis. They had deferred costs of $144 million at the end of 2019.

On the 1Q20 call, management noted that during COVID the Defense Department wants to support the defense industry and their suppliers. Thus, it is accelerating RFPs (Requests for Proposal), payments on current contracts, and progress payments are being boosted from 80% of the total to 90%. Given that the retirement costs are paid via billings being collected as revenues – it seems very possible to us that GD will be able to bill for more of the pension costs and could see that cash arrive in 2020. On top of that, if share repurchases are on hold, it could devote more cash toward funding the pension plan and shrinking the underfunding level.

GD focuses on tax incentives when deciding how much to fund the pension. There are two other incentives for GD to put more cash into the pension plan. The first is it would lower the unfunded liability and reduce the debt figure in the denominator of their ROI calculation and effectively boost ROI. The second is they use an expected rate of return on pension assets of 7.46% while the interest cost is calculated at 3.19% this year. GD could boost income by shrinking the net pension cost:

pension expense	2020e	2019	2018	2017
Service Cost	$110	$111	$180	$168
Interest Cost	$578	$600	$532	$453
Exp. Rate of Return	-$983	-$911	-$856	-$679
Recognized Actuarial Loss	$300	$326	$359	$362
amort. Prior service credit	-$5	-$19	-$46	-$66
Pension Cost	$0	$107	$169	$238

The pension cost is likely to decline in 2020 without paying more into the plan. GD is planning to put $470 million into the plan assets this year and it will pay out $853 million in benefits. The payouts lower both PBO and plan assets. But conceptually, adding $400-$500 million to pension contributions this year should set GD up to have a pension cost near $0 or even a slightly negative figure. A $100 million change in pension cost is worth about 27-cents to GD's EPS.

Unbilled Receivables May Turn into Cash Faster Too

There are a number of long-term contracts at GD. As it completes the work, it recognizes revenue and that creates a receivable on the balance sheet. Some contracts have a prescribed billing schedule set up as well. Thus, GD has two different receivable accounts, both represent work that has been completed and it has recorded the revenue. One where they have sent an invoice to the customer and a second where the contract doesn't allow billing yet and an invoice will be sent later.

We would believe that if the company is growing and starting new contracts (as GD attributes the lower operating margin in 2019), there would be some advance deposits made but the billing may be delayed. The result should be that unbilled receivables would rise. In recent years, unbilled receivables have been a drag on cash flow:

	2019	2018	2017
Unbilled Revenue	$33,481	$27,908	$21,845
Advances/Progress Payments	$25,624	$21,332	$16,605
Unbilled Receivables	$7,857	$6,576	$5,240
Unbilled Rec on cash flow	-$1,303	-$800	-$987

The increase in 2019 and 2018 had one particular sale for an international order for armored vehicles through the Canadian government. In 2018, this was $1.9 billion of unbilled receivables and in 2019, it was $2.9 billion. There was a $500 million payment received in early 2020 and another $500 million was received in 2Q20 as the payment schedule has been revised. If the unbilled receivable is scheduled to decline on that order – it should help cash flow.

In addition, if the US government is making more advance payments, accelerating payment times, and boosting the percentage of contract payments made – that should enable more of these unbilled receivables to become billable more quickly. GD notes that most invoices are paid monthly or monthly. The net result could be that this source of about $1 billion in annual cash drain for the last three years may become a cash generator in 2020.

Charles River Laboratories Intl. (CRL)
EQ Update- 3/20 Qtr

Current EQ Rating*	Previous EQ Rating
4-	4+

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

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

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We lower our earnings quality rating to 4- (Acceptable) from 4+ (Acceptable) indicating a slight decline in earnings quality given the rise in the add-back of amortization of acquired intangibles.

- CRL acquired HemaCare Corporation on January 3 of 2020 for $380 million. Of the $376 million net purchase price, $209 million was booked as goodwill and $184 million as definite-lived intangibles. Of the intangibles, over 90% was booked as "client relationships and is being amortized over 19 years. The 19-year time frame seems somewhat long at first glance and even more so when one considers the client relationships from last year's Citoxlab deal are being amortized over 13 years. Of course, the amortization period is not relevant to non-GAAP earnings which enjoy the benefit of adding back amortization of acquired intangibles. However, amortization as a percentage of non-GAAP operating income has risen to 23% from 12% two years ago. CRL still posts solid organic growth adjusted for acquisitions so it is not dependent on acquisitions to drive meaningful growth. Nevertheless, the increase in amortization added back to non-GAAP earnings prompts us to lower our rating to a 4- from a 4+.

- CRL's effective tax rate of 14.3% was 300 bps lower than the year-ago quarter courtesy of a larger than expected benefit from stock-based compensation. This added over 6 cps to earnings growth in the quarter. However, this benefit is not material when viewed against the 38 cps earnings beat for the quarter.

- Losses from venture capital investments totaled $12.2 million in the 3/20 quarter versus $10.6 million in gains in the year-ago quarter. These gains and losses are always adjusted out of non-GAAP results. While we agree the volatility associated with these gains and losses requires some adjustments to determine a true profit growth rate, investors should remember that these amounts can regularly equal in the mid-teens as a percentage of non-GAAP net income.

- Lower stock-based compensation added about 3 cps to growth in the 3/20 quarter.

Lancaster Colony (LANC) EQ Update- 3/20 Qtr

Current EQ Rating*	Previous EQ Rating
4+	3+

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

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

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We are raising our earnings quality rating to 4+ (Acceptable) from 3+ (Minor Concern).

- Our past concerns with LANC included one-time gains from reductions in the value of contingent consideration stemming from disappointment surrounding the Angelic acquisition, rising payables, and lower stock-based compensation boosting growth. Changes in contingent consideration had a negligible impact on comparisons in the 3/20 quarter and lower stock compensation reversed in the 3/20 quarter, becoming almost a penny per share headwind.

- Payable days continue to rise, climbing over 5 days over the year-ago level after adjustment for construction costs payable. While stretching payables is a low-quality source of cash flow growth, LANC's payable days are still just over 30 which is by far an industry low. Considering many of its peers' DSPS are well in excess of 60 days, LANC is not in danger of this benefit reversing any time soon.

Fortune Brands (FBHS) EQ Update- 3/20 Qtr

Current EQ Rating*	Previous EQ Rating
4+	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
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*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We are raising our earnings quality rating on FBHS largely due to the improvement in inventories during the quarter.

- FBHS's inventory DSIs fell by 6 days compared to the 3/19 quarter. This represents a reversal of a trend in rising inventories that have been a point of concern in previous reviews. While management had previously indicated that inventories would begin to normalize after the first of the year, we note that the company attributed the decline in inventories to supply chain disruptions related to COVID-19 and higher than expected sales. Regardless, the company seems to be in a better position with inventories which alleviates one of our larger points of concern.

- FBHS's tax rate adjusted for one-time items fell by 350 bps due to the tax benefit of stock options. This added over 4 cps to earnings in the period which was likely unexpected by analysts. However, the company beat earnings estimates by 9 cps in the quarter, so the outperformance was not wholly attributable to the tax benefit.

- In January, FBHS entered into an agreement to buy the remaining interest of its minority investment in Flo Technologies in stages over the next year. At the end of the 3/20 quarter, the company owned 75% of Flo Technologies, but due to substantive participation rights held by the minority owners, FBHS determined that it did not have controlling interest which resulted in the investment being accounted for under the equity method rather than being consolidated. When the substantive participation rights expire in early 2021, Flo's results will be consolidated. The newly enacted ASC 2020-01 required the company to remeasure the value of its investment in Flo Technologies prior to adopting the equity method of accounting. This resulted in a $6.6 million gain which was recognized in other income but removed from non-GAAP earnings.

- We have cited the long string of goodwill and intangible charges at FBHS over the last several quarters. The trend continued into the first quarter as COVID-19 required a remeasurement of assets resulting in a $9.5 million write-down to trade names in the cabinet segment. The value of this tradename was $29 million at the end of the quarter. Impairment testing on two more tradenames with a combined carrying value of $120 million revealed that fair value exceeded carrying value by less than 10%. This indicates we still may have not seen the last of the impairment charges.

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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