BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Mohawk Industries (DOW) EQ Update
Lawsuit Details

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

MHK's stock price took a 20% hit last week after a detailed filing related to a shareholder lawsuit originally filed in January of this year contained damning details regarding alleged accounting fraud. This was followed up this week by news of subpoenas from the SEC as noted in the following from an 8-K filed on 7/13:

> *"On June 29, 2020, an Amended Class Action Complaint for violations of federal securities laws was filed against Mohawk and its CEO Jeff Lorberbaum in the*

> *Northern District of Georgia. The complaint alleges that the Company (1) engaged in fabricating revenues by attempting delivery to customers that were closed and recognizing these attempts as sales; (2) overproduced product to report higher operating margins and maintained significant inventory that was not salable; and (3) valued certain inventory improperly or improperly delivered inventory with knowledge that it was defective and customers would return it. The Company intends to vigorously defend itself in the lawsuit.*
>
> *On June 25, 2020, the company received subpoenas issued by the U.S. Attorney's Office for the Northern District of Georgia and the U.S. Securities and Exchange Commission on topics similar to those raised by the amended complaint. The company is cooperating with those authorities."*

Given this is an accounting-related lawsuit plus the unusual degree of wrongdoing alleged, we wanted to weigh in on the credibility of the allegations and the potential impact on the stock going forward.

- The lawsuit covers the period from 4/28/2017 to 7/25/2019 during which time the company was alleged to have covered up a massive buildup of faulty inventory. Also, the complaint alleges that the company created fictitious sales through an elaborate scheme to ship vast amounts of product on the last Saturday of the quarter and booking it as revenue despite knowing customers would not be available to receive it. We began coverage of MHK after the 6/18 quarter and regularly cited the rising inventory as a problem. However, we note that receivables growth was not out of line during our coverage period until the 6/19 and 9/19 quarters with the latter quarter taking place after the scheme allegedly stopped.

- On the inventory matter, the company allegedly was having massive problems with its US LVT (luxury vinyl tile) factory with 50% of the product produced being unsalable. The company is accused of ramping up production of LVT in order to artificially inflate gross margin by spreading fixed costs over more units. We cited the rising inventories and management's various explanations of rising raw materials costs, plant expansions, and tariff pre-buying. The complaint alleges that the company had warehouses full of scrap product that could never be sold. While it is no secret that the company had inventory issues, we are somewhat skeptical that the scrap problem was as dramatic as the allegations indicate given that the growth in inventory leveled out by the 12/19 quarter and the company has yet to take a large inventory write-off. If we don't see a write off in the next couple of quarters, it will definitely cast doubt on the credibility of the complaint. We also note that the company uses the FIFO method of accounting which would delay the beneficial impact of increasing production by a quarter.

- The second major component to the complaint was the "Saturday Scheme" which was an alleged plot to compensate for problems with the LVT product as well as weakening demand for other products by booking fictitious sales. Trucks were allegedly loaded to attempt delivery on the last Saturday of the quarter knowing that customers would not be there to receive it. Product was allegedly booked as revenue at the time delivery was attempted but booked as returns for the following quarter after delivery failed. Such a scheme would seem to result in a large, sustained rise in accounts receivable DSOs. While DSOs did show a 3.5-day jump in the 7/17 quarter, the YOY increases in the 9/17 and 12/17 quarters fell to less than 2 days. After the 12/17 quarter, DSO growth essentially was flat or down until the 6/19 quarter after which the scheme had reportedly come to an end. While there could have been channel stuffing activity in the last half of 2017, we do not see evidence of a sustained and growing scheme to drive up revenue during the whole period under question.

- Our overall take is that while the company could get dinged from the lawsuit, the wrongdoing may not have been as dramatic as a reading of the complaint would seem to indicate.

- We would note that while it may sound like we are defending the company, we do not view MHK's reporting as being in any way clean. In addition to criticizing rising inventories during our coverage of the company, we have cited cuts to bad debt allowances and the warranty reserve as well as unusual movements in amortization of costs to obtain contracts that have all benefited past quarters. MHK is one of the few companies on our coverage list that has spent time with a 2 (Weak) rating.

Background

We initiated earnings quality of coverage of MHK on 8/13/2018 with an initial rating of 3- (Minor Concern) based on our analysis through the 6/18 quarter. That quarter was a disaster in itself with EPS missing targets by $0.39 resulting in a 15%+ stock price decline. We noted that inventories had been rising for several quarters. The company had already admitted that inventories were too high and it committed to work to bring them down. In addition to the rising inventories, we noted unusual benefits from cuts to bad debt allowances and the warranty reserve. Over the following quarters, inventories continued to rise with the company citing multiple factors for the rising balances including rising raw materials costs, opening new plants, and pre-buying ahead of tariffs. We stated in our 11/8/2018 review that "All of these factors make us think we have not seen the last of the negative impacts from the company's inflated inventory balances."

Finally, in the 6/19 quarter, the company reported a 2 cps earnings miss, a sizeable top-line miss, and 12% lower guidance for the 9/19 quarter citing tougher market conditions and excess channel inventory as the culprits. We chose to lower our earnings quality rating to 2- (Weak) due to a 2.5-day jump in receivable DSOs, continued reduction in bad debt reserves, and a decline in costs for amortization of contract costs.

In early January of 2020, MHK disclosed that it was the subject of a shareholder lawsuit related to the stock price decline resulting from the earnings disappointment:

> *"The Company and certain of its present and former executive officers were named as defendants in a putative shareholder class action lawsuit filed in the United States District Court for the Northern District of Georgia. The complaint alleges that defendants violated the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by making materially false and misleading statements and that the officers are control persons under Section 20(a) of the Securities Exchange Act of 1934. The complaint is filed on behalf of shareholders who purchased shares of the Company's common stock between April 28, 2017 and July 25, 2019. The Company believes the claims are frivolous and intends to defend them vigorously."*

The original complaint filed in early January indicated that the alleged wrongdoing took place from 4/28/2017 to 7/25/2019. During that time suit alleged that "Mohawk engaged in a scheme to inflate its revenues and earnings by booking fictitious sales of those products." However, little detail was given. The lead plaintiff in the case was the Public Employees Retirements System of Mississippi (MERS).

The stock lost some ground in January with the news of the original complaint but the market seemed to quickly shrug it off. However, last week, an amended complaint emerged with detailed accounts from multiple ex-employees of how the company allegedly actively sought to hide excess, faulty inventory and artificially boost sales through an elaborate scheme of faking shipments to customers. This news knocked the stock down more than

20% and it is currently down about 15% as of this writing. We will take a closer look at the allegations and attempt to gauge their credibility by examining the reported numbers.

Allegations of Hiding Faulty Inventory

The complaint essentially has two main components: 1) MHK tired to hide a buildup of faulty inventory, and 2) it tried to hide disappointing sales growth by artificially stuffing the channel. We examine the inventory issue first.

LVT (luxury vinyl tile) became extremely popular in the flooring industry a few years ago and quickly became the fastest-growing segment in the industry. MHK chose to enter the LVT market by acquiring a Belgian producer of the product, IVC Group, which had a new US manufacturing plant in Georgia. However, the complaint alleges that:

- The US production line had problems from the beginning and was turning out a huge amount of faulty product which customers were not accepting. MHK's former VP of Sales for the Builder and Multifamily division reportedly said that roughly 50% of LVT produced during the class period was unsalable scrap and he would not allow his sales team to sell it.

- Management allegedly made false statements about its ability to sell inventory, claiming it was selling all of the LVT it was producing and its sales growth was limited by capacity constraints.

- Despite the faulty inventory being marked as scrap, it was recorded in net inventory on MHK's balance sheet. The complaint documents multiple ex-employees testifying that warehouses were full of boxes of returned product that had no use.

- Inventory days of sales steadily rose, and management gave multiple allegedly misleading excuses including rising raw materials costs, plant expansions, and pre-buying ahead of tariffs.

- Despite the buildup, the company continued to produce product rapidly to boost margins by spreading fixed costs over a larger number of goods.

So, how valid are these allegations? Let's take a look at inventory days of sales for the last four years by quarter:

	3/28/2020	12/31/2019	9/28/2019	6/29/2019
Total Inventory	$2,195.434	$2,282.3	$2,338.0	$2,367.6
Cost of Products Sold	$1,669.323	$1,801.705	$1,827.494	$1,847.867
DSI	115.7	119.1	116.4	116.6

	3/30/2019	12/31/2018	9/29/2018	6/30/2018
Total Inventory	$2,338.1	$2,287.6	$2,214.3	$2,061.2
Cost of Products Sold	$1,817.563	$1,802.228	$1,825.367	$1,810.459
DSI	114.5	118.0	110.4	103.6

	3/31/2018	12/31/2017	9/30/2017	7/01/2017
Total Inventory	$2,045.0	$1,948.7	$1,911.0	$1,865.9
Cost of Products Sold	$1,707.510	$1,615.473	$1,665.209	$1,673.902
DSI	107.8	111.0	104.4	101.4

	4/01/2017	12/31/2016	10/01/2016	7/02/2016
Total Inventory	$1,740.9	$1,675.8	$1,673.2	$1,660.1
Cost of Products Sold	$1,540.292	$1,491.567	$1,567.580	$1,554.748
DSI	102.9	102.2	97.1	97.2

Remember that the complaint contends that the unusable inventory was building up between 4/28/2017 to 7/25/2019. There is no denying that inventory levels rose significantly during this time frame, a fact we were critical of at the time. Although inventory levels are still at historically high levels, the growth leveled out in the 12/19 and 3/20 quarters. However, we are somewhat skeptical of the claim that there were warehouses full of scrap product that the company could do nothing with given that absolute inventory levels actually declined in the 12/19 and 3/20 quarters without a large write-down of inventory.

With regards to the point that the company was purposefully boosting margins by ramping production despite literally tons of unusable inventory in the warehouse, we would point out that the company uses 100% FIFO inventory accounting. This would make this a longer-term scheme as the resulting lower cost inventory would be put at the back of the line to be expensed and with over a quarter of inventory on hand, such production-induced cost benefits would not be seen until the next quarter.

Our take on this issue is that there is no doubt the company had an inventory problem which was discussed prominently on multiple conference calls. However, there has yet to be a write-off and inventories have actually declined YOY in each of the last two quarters.

This makes the proposition that there was a 15-day increase in inventories driven by warehouses full of scrap flooring seem a little stretched. Still, if even part of the story is true, it could result in a negative outcome in the lawsuit.

Allegations of Generating Fictitious Sales

The most damning accusation involves the company's alleged scheme to generate fictitious sales. The complaint contains accounts from multiple ex-employees involved in areas such as distribution and IT who tell of the company's so-called "Saturday Scheme" to report growing sales despite waning demand for its products.

- Executives allegedly directed distribution employees to load trucks with product on the last Saturday of the quarter and attempt delivery even though they knew it was unlikely anyone would be there to accept.

- These products were allegedly counted as sales at the time they were checked out for delivery even though the company's accounting policy indicates it recognizes revenue upon delivery. The complaint alleges that ex-employees said the scheme involved "several million pounds of product" across almost all product lines, not just LVT.

- Amounts that came back undelivered were supposedly accounted for as returns for the next quarter. Over time, some warehouse workers allegedly stopped even attempting delivery and simply marked the items as sold without even loading the truck.

- Several ex-employees were quoted in the complaint as being aware of the "Saturday Scheme" and indicated that it was well-known by many at the company. One employee claimed the scheme was already in place when he joined the company in February of 2017.

The allegations paint a picture of channel stuffing taken to the extreme, but is there evidence of it in the numbers? If the company was indeed booking undelivered items as revenue on the last day of the quarter, we should see a steady rise in accounts receivable as that is the only place the revenue could be booked. The following table shows accounts receivable DSOs for the last four years by quarter. Note we are using "customer trade receivables" and excluding tax receivables and other receivables. Details of the composition of other receivables is not available but they have remained very flat on a days of sales basis over the period in question implying they were not part of any channel stuffing scheme.

	3/28/2020	12/31/2019	9/28/2019	6/29/2019
Sales	$2,286	$2,425	$2,519	$2,584
Trade Receivables	$1,612	$1,492	$1,763	$1,794
Trade Receivables Days of Sales	62.0	57.8	63.7	63.2

	3/30/2019	12/31/2018	9/29/2018	6/30/2018
Sales	$2,442	$2,449	$2,546	$2,577
Trade Receivables	$1,717	$1,562	$1,727	$1,717
Trade Receivables Days of Sales	62.6	59.3	61.7	60.6

	3/31/2018	12/31/2017	9/30/2017	7/01/2017
Sales	$2,412	$2,369	$2,449	$2,453
Trade Receivables	$1,675	$1,538	$1,661	$1,652
Trade Receivables Days of Sales	62.5	59.7	61.7	61.3

	4/01/2017	12/31/2016	10/01/2016	7/02/2016
Sales	$2,221	$2,183	$2,294	$2,310
Trade Receivables	$1,509	$1,386	$1,524	$1,466
Trade Receivables Days of Sales	61.8	57.8	60.4	57.7

The complaint also alleges that the company took a break from the Saturday Scheme in the 6/18 and 9/18 quarters as it was already going to miss revenue targets so badly that management didn't even try to boost the numbers. The following table compares the receivables increases to sales and earnings beats to see if there is a correlation between the size of the beat or miss and the movement in receivables:

	3/28/2020	12/31/2019	9/28/2019	6/29/2019
Revenue Beat (millions)	$0.230	$0.250	$12.940	-$64.540
EPS Beat	-$0.01	$0.05	$0.11	$0.02
DSO Change	-0.5	-1.5	2.0	2.5

	3/30/2019	12/31/2018	9/29/2018	6/30/2018
Revenue Beat (millions)	-$56.960	$14.290	-$58.270	-$8.020
EPS Beat	$0.07	$0.04	-$0.29	-$0.39
DSO Change	0.1	-0.4	0.0	-0.7

	3/31/2018	12/31/2017	9/30/2017	7/01/2017
Revenue Beat (millions)	$10.930	$4.700	-$7.230	$3.780
EPS Beat	$0.01	$0.10	$0.02	$0.13
DSO Change	0.6	1.9	1.3	3.5

We do see suspicious 2-3-day jumps in DSOs in the 7/17-12/17 quarters. However, following that time, DSOs were quite flat, and even posted two YOY declines during the period in question. Also, we can see that there were substantial earnings misses in the 6/18 and 9/18 quarters during which time DSOs were flat to down which does match the claims in the complaint. However, during our coverage of the company since the 6/18 quarter, we only called the company out for rising receivables in the 6/19 and 9/19 quarters. Note that by the 9/19 quarter, the scheme had supposedly already ended.

In our experience, channel stuffing is a scheme that typically snowballs over time. Once a company has pulled sales into a particular quarter, it is already behind on the next and must either grow sales organically or become more aggressive at stuffing the channel at the end of the next quarter to keep showing growth. The complaint seems to paint the picture of a scam that grew over time to the point that the majority of the company knew about it and the company would have posted anemic or negative growth without it. For that to be the case, we would have expected to see receivables DSOs jump from 60 to 80, not 60 to 63. The 3.5-day jump in DSOs in the 7/17 quarter does look suspicious and we would not argue with the conclusion that the channel was stuffed then, but that was followed by small YOY jumps in the next two quarters followed by negligible jumps and declines. Our take on this claim is that the Saturday Scheme may not have been as long-lived or widespread as the complaint indicates. Still, the number of ex-employees testifying to the scheme and the DSO jumps in 2017 could indicate there is enough for a negative outcome for the company in the lawsuit.

Kroger (KR) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
5+	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 are upgrading our earnings quality rating to 5+ (Strong) from 4+ (Acceptable)

Kroger's margins benefitted from selling fewer gallons of gasoline which is lower margin in the first place – volume was down 24.6% in 1Q20. It also benefited from earning 48-cents per gallon vs. 23-cents the prior year. We estimate this to be a 21-cent boost to EPS in 1Q20 and a boost to cash flow of about $168 million. As the country has opened more, fuel is returning to normal margins with lower volumes and Kroger is forecasting a $50-$100 million headwind for the 2Q20 or 5-10-cents of EPS.

Our initial rating focused on potential problems with multi-employer pension plans and the company being at the high-end of its debt target. Both situations have improved in recent quarters and we are boosting the rating for four reasons:

- **Multi-Employer Pensions have received higher funding in 2019 and 1Q20. KR's share of underfunding has fallen by $800 million since the end of 2018.** KR's debt target is to be at 2.3-2.5x EBITDA – it is now at 1.8x without this pension debt or 2.2x with it. That is down from 3.0x a few quarters ago.

- **The restructuring efforts and capital improvements in digital have helped boost sales and leverage those higher sales with margin gains. The higher operating earnings should drive higher cash flow as well.**

- **Inventory provided a large boost to cash flow in 1Q20 that will likely reverse going forward as KR wants to get stores back to pre-COVID levels of inventory to avoid**

out-of-stocks. DSIs fell by 3-days in 1Q20. Other segments of working capital are helping cash flow due to higher sales as well and should keep working capital as a cash generator in 2020 even as inventory levels increase. Total working capital changes produced $1.3 billion in cash from operations in 1Q20,

- **Adjustments to EPS remain very benign.** We still give Kroger high marks for not adding back restructuring charges, new investments in employees, and COVID related costs. In recent quarters the only adjustments made are a mark-to-market gain/loss for a stock holding, issues for a divestment, and contingent liabilities for an acquisition meeting a milestone. Those all appear non-operating and one-time in nature.

The Multi-Employer Pensions Received More Sizeable Infusions of Cash from Kroger in Fiscal 2019 and 1Q20

Kroger continues to believe that its contributions will be elevated in the coming years – the same warning language that was in the 10-K for fiscal 2018. Here's what is different:

  - **KR's share of underfunding for these plans is lower by $800 million** – some of that is due to a higher expected rate of return on the assets:

Multi-Emp. Plans	1Q20	2019	2018	2017
KR Contribution	$236	$461	$358	$954
KR Underfunding Share	n/a	$2,300	$3,100	$2,300

  - **KR's range for net-debt to EBITDA is 2.3-2.5x. In our initial EQ review, the ratio was 2.46x. It is now 1.81x.** Also, the company's share of underfunded pension debt was $3.1 billion and KR warned that could be viewed as debt that would boost its debt ratio 3.00x. It still has that warning in the latest 10-K, but adding the $2.3 billion would still have the ratio at 2.18x – below Kroger's range. **Debt fell by $600 million in 1Q20 and what really moved the ratio down was the cash balance rising by $2.3 billion.** We expect some of that cash to reserve back out in future quarters, as we'll discuss below – **but even**

if they lose $1 billion and add in the $2.3 billion in pension debt – KR would still be at the low-end of its leverage target of 2.34x net debt/EBITDA.

KR's Operating Profit is Rising as the Costs Savings from the Restock Kroger Plan Are Seen and Higher Sales Are Being Leveraged More

Some of this in 1Q is clearly due to COVID issues – but sales are remaining strong. If we remove the impact of fuel margins in 1Q20 – adjusted operating profit would have been about $1,232 million or about 3.0% of sales. Excluding fuel and the pension contribution, KR reported margins were up 54bp to 3.1%.

Op Results	1Q20	1Q19	4Q19	4Q18	3Q19	3Q18
Sales	$41,549	$37,251	$28,893	$28,286	$27,974	$27,831
Adj Op. Profit	$1,453	$957	$758	$628	653%	$664
Margin	3.5%	2.6%	2.6%	2.2%	2.3%	2.4%

The first-quarter results are punished further by adding all the COVID safety issues for cleaning, testing, barriers, and additional staff for on-line orders and stocking. Even if fuel is a headwind in 2Q of $50-$100 million, 2Q19 is an easy comp where margins before fuel were down 15bp last year. Higher sales in 2Q20, leveraging those over fixed costs, and the cost savings being seen – could be worth $350-$500 million in higher operating profit. The pension cost of 1Q20 is unlikely to recur as well. That should more than offset the fuel headwinds.

It is also important to note that with operating profit up $500 million in 1Q and likely up about $300 million in 2Q – that is a net positive of $600 million incremental cash flow after taxes. Capital spending for the year is only forecast to rise $100-$300 million to $3.2-$3.4 billion in 2020. The free cash flow figure should already be coming in above last year.

Inventory Tailwind on Cash Flow May Reverse in Coming Quarters

While income was clearly surging in 1Q20 and helping cash from operations rise by $2.0 billion y/y – working capital contributed $1.3 billion of the total. Some of that is due to rising sales, costs, and employees. Some of that is due to receivables being a small part of working capital to be a drain on cash flow as sales grow. We noticed Accounts Payable rose by $783 million vs. $364 million the year before – adding $419 million to cash flow. Inventory also fell by $746 million vs. a decline of $124 million in 1Q19 – adding $622 million more to cash flow in 1Q20.

	1Q20	1Q19
Cash from Ops	$4,265	$2,268
Decline in Inv.	$756	$124
Increase in A/P	$783	$364
CFO without Inv/AP	$2,726	$1,780

In the case of accounts payable – we do not see a problem. It rises seasonally in 1Q and the jump in sales explains most of it. The Days Payable only rose by 0.5 days:

	1Q20	4Q19	3Q19	2Q19
DSPs	20.7	25.7	28.5	26.0

	1Q19	4Q18	3Q18	2Q18
DSPs	20.2	25.2	27.4	24.7

Inventories are another issue – they declined more seasonally amid rapidly rising sales than the year before and the DSIs declined by 3 days:

	1Q20	4Q19	3Q19	2Q19
DSIs	22.4	34.3	36.3	32.5

	1Q19	4Q18	3Q18	2Q18
DSIs	25.2	33.8	35.2	31.2

According to management, inventories are likely to rise going forward in dollars and DSIs. On the 1Q20 call it was noted,

> *"if you look at our supply chain team working with our merchants, **we're getting the stores' inventories back up to pre-COVID level, so the in-stock position improves**, the continued focus on Fresh and continuing to even – Fresh was a priority already, but making sure that the products that customers get stays fresh and then with a friendly smile or an incredibly easy digital experience."*

While that should offset some of the cash flow seen in 1Q20 – overall working capital is expected to be a cash generator in 2020:

> "*We expect working capital to improve for the year, although not to the level experienced in the first quarter which was inflated by the extraordinary sales growth due to COVID-19."*
>
> *"We certainly were thrilled with the cash balance that we generated during the quarter. Part of that does reflect improved operating performance. Part of it was a significant improvement in working capital… But some elements of that will be inflated just because of the higher sales in the first quarter and the way our working capital cycle works and some of these are also related to the Cares Act where there is a delay in certain tax payments as part of the way that the Cares Act was structured. So, we would expect as a result of all of that, still to generate incremental free cash flow this year."*

Adjusted EPS Remains Very Clean

When we first addressed Kroger – we were impressed that it is not adjusting results to add back the costs of the Restock Kroger Program. It also has not added back items like the contributions to multi-employer pension plans when it reports adjusted EPS.

The most common change is the mark to market gain/loss of its share in Ocado. This is the company that Kroger partnered with to build out its logistic upgrades. The other items are understandable as one-time items:

EPS Adjustments	1Q20	4Q19
GAAP EPS	$1.52	$0.40
MTM Ocado	-$0.40	$0.01
Chg. to Chef deal	$0.06	-$0.05
Transformation Chg.	$0.04	$0.04
Withdrawal from Pension	$0.00	$0.01
Impairment to Divest Lucky's	$0.00	$0.16
Adjusted EPS	$1.22	$0.57

The Chef acquisition has contingent payments based on the unit hitting milestone targets. That contingent portion is revalued and results in changes in the value. The transformation is related to closing some stores and Lucky's was deconsolidated. Kroger also withdrew from one of the pension plans.

We consider the company's earnings quality to be above average given the nature of the adjustments and how many other things Kroger could be adding back related to COVID, increased spending on digital tools, and the restructuring since 2017.

RealPage (RP) EQ Update- 6/20 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

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

It has been a busy week for RP. The company announced its CFO is leaving next month. The next day it announced that it expects to top the high-end of all its guidance metrics for 2Q20 when results are released on July 30.

We still see many red flags for earnings quality and sustainability at RP. Investors should also remember that RP slashed forecasts after 1Q results, making a "beat" in 2Q much less impressive. This is still largely a software company that collects its fees upfront as deferred revenue – hitting forecasts on revenue and adjusted EBITDA (adding back everything but the kitchen sink including stock compensation and all costs of acquisitions) should not be too difficult, but it appears it is getting tougher at RP.

- **Reduced forecasts call for 2Q20 to come in below 1Q20 and 2Q19 levels.** During 2019 and 2020, RP has made six acquisitions for $763 million. Those companies had over $80 million in revenue and the pro forma figures from RP's 10-Q shows quarterly revenue should be $277 million. RP's 2Q forecast is $276-$280 million with EPS lower than 2019. Organic growth may be zero at this point.

- **Deferred Revenue is a problem for growth also.** If organic growth is low, RP should at least have the benefit of collecting fees in advance and having the quarter largely "baked in." **However, deferred revenues have been falling**.

- **RP has cut R&D spending to help EPS of late by 2-4 cents per quarter. It also reduced its tax rate assumption for 2020 which helps 1Q EPS by 1-cent.**

- **Acquisitions are a way of life for RP, yet it is not self-funding on them. It stretches earnings by not amortizing the bulk of acquired assets at all and where it does amortize – it uses a longer life schedule than largely identical assets built in-house.** RP had 48-cents in non-GAAP EPS in 4Q19 and 43-cents in 1Q20. Goodwill amortization over 40 years would lower those figures by 11-cents. Adding back the amortization of other acquired intangibles was another 16-cents and 20-cents of that quarterly non-GAAP EPS.

- **RP appears to have spent years under-investing in equipment as the company has doubled sales, but still spent the same amount on capital expenditures for 3-years.** The gap between depreciation and amortization vs. capital spending has narrowed and depreciation and amortization have been flat for four quarters now. In 2020, it appears, capital spending is now rising – that could create a headwind for EPS.

The Forecasts Should Not Be Tough to Beat – But Forecasts Point to Zero Growth

Investors should remember that RP started 2020 with forecasts of for growth of 18%-20% on revenue, 14%-15% growth of adjusted EBITDA, and 11%-14% non-GAAP EPS growth. We think investors should have already been alarmed because much of that growth would have come from acquisitions already made. The proforma revenue figure for 2019 assuming the acquisitions had occurred at the start of the year was $1,059 million. That means RP was only planning for 10%-12% organic top-line growth after cross-selling its existing clients the new services it bought.

After 1Q20, the forecasts were slashed for the year:

Guidance	2020b	2020a	2019
Revenues	$1114-1154	$1163-1183	$988
Adj. EBITDA	$290-300	$320-324	$282
GAAP EPS	$0.22-0.33	$0.29-0.35	$0.60
non-GAAP EPS	$1.74-1.84	$1.95-$2.00	$1.76

Growth is now expected to be only 13%-17%, or organically 5%-9%. EPS growth is expected to be flat and EBITDA only rising 3%-6%. It appears that margins are expected to be squeezed too.

RP spent $763 million making six acquisitions in 2019 and 2020 so far. We cannot find a revenue figure for two of the deals, but the other four had $80 million in annual sales. **According to the 1Q20 10-Q, the proforma sales for these deals was $277 million for 1Q20. That is exactly what RP reported. Organic growth may be zero now with a 2Q forecast of $276-$280 million.** The forecasts for 2Q20, call for all the metrics to decline – not just from 1Q, but from 2Q19 (except revenue) and 2Q19 did not include the recent acquisitions.

Guidance	2Q20	1Q20	2Q19
Revenues	$276-280	$277	$244
Adj. EBITDA	$66-70	$72	$68
GAAP EPS	$0.00-0.05	$0.06	$0.16
non-GAAP EPS	$0.38-0.42	$0.43	$0.43
# of Shares	94.7	93.7	94.0

Investors should also keep in mind that RP regularly beats forecasts – but they aren't crushing estimates. Their last eight quarters of beats are:

	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18	2Q18
EPS Beats	$0.01	$0.01	$0.00	$0.00	$0.00	$0.02	$0.03	$0.00

The declining deferred revenue as days of quarterly sales also makes RP more dependent on writing new business in the current quarter than it needed in the past.

Def. Rev Days	1Q	4Q	3Q	2Q
2020/2019	48.4	51.5	47.5	49.9
2019/2018	50.6	52.6	49.0	51.3
2018/2017	54.5	61.9	61.5	63.1

Other Areas Where EPS Has Already Been Stretched

We discussed much of this after the 1Q20 results, but we will reiterate them here to remind readers about other earnings quality issues for RP.

- RP has been cutting R&D to make earnings and adding 2-4 cents per quarter of late.

In 1Q20, R&D rose in dollar terms, but still declined as a percentage of sales.

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

- **RP relies on acquisitions for some of its R&D and it has now made 46 deals.**
    - The first problem is **RP is not self-funding for these deals**, yet if it doesn't do them, organic growth is not as impressive as reported growth. Being free cash flow negative is a problem in our view. That is why RP just issued more stock – to repay revolver debt and deal with dilution on convertible notes used to fund deals.

	1Q20	2019	2018	2017
Cash from Ops	$61.6	$317.0	$244.8	$140.3
Capital Exp.	$13.3	$51.5	$50.9	$49.8
Acquisitions	$59.5	$665.8	$278.6	$649.9
Free Cash Flow	-$11.2	-$400.3	-$84.7	-$559.4

    - The next problem is that **had RP built these assets in house, the wages would have been expensed as incurred and the equipment amortized over 3-5 years. Instead, the bulk of the acquired assets are goodwill of $1.66 billion and are not amortized at all.** Even over 40 years, it would be costing RP 11-cents in EPS per quarter.
    - **The intangibles that are amortized are largely developed technology over 3-7 years and client relationships over 3-10 years. Internally-developed**

software is amortized over 3-5 years and sales commissions for signing up a new client are amortized over 3 years. That stretching is boosting GAAP results, and the fact that RP adds back the amortization of acquired assets as "non-recurring" items boosts non-GAAP results. In 4Q19, adding this cost back was 16-cents of the reported 48-cents of non-GAAP EPS. In 1Q20, it was 20-cents of the reported 43-cents.

- **RP picked up 1-cent in 1Q20 by assuming a 24% tax rate** down from 26% in 2019 for its non-GAAP EPS. That alone is the 1-cent beat in 1Q.

- **We also continue to believe that RP is underinvesting in equipment and the lower depreciation is helping EPS.** Capital spending was $75 million in 2016 and has now been $50 million for three straight years. During that time, RP made $1.7 billion in deals, assets are up four-fold, and sales have more than doubled. Yet, capital spending is down to flat. Capital spending has not risen even though depreciation and software amortization has increased:

	2019	2018	2017
Depreciation	$30.2	$28.5	$27.2
Amortz. Software	$14.8	$11.9	$8.0
Dep/Amortz.	$45.0	$40.4	$35.2
Capital Spending	$51.5	$50.9	$49.8

	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

Depreciation and amortization have been basically flat for four quarters at this point as sales have risen 18%. This looks like an area where investors should expect more headwind on costs. In 1Q20, capital spending did increase by over $2 million and RP guided to 2Q spending for $2-$3 million more so employees could work remotely. They amortize this over 3-5 years. If the equipment upgrade is finally beginning – every $1.25 million increase in depreciation expense is worth 1-cent in EPS.

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.

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