BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Twitter (TWTR) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3+

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

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

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

We maintain our earnings quality rating at 3+ (Minor Concern)

Overall, we believe Twitter has corrected many of the issues we initially had problems with such as its cash flow, cutting R&D and capital spending, and being free cash flow negative if it could not pay for things with stock. We may have raised this rating without COVID hurting recent revenues and causing cash flow to decline.

Our biggest issue is now Twitter's deferred tax asset accounts and valuation reserves that were set up. The company appears to have set itself up to beat forecasts going forward by reversing the reserve back into earnings like it did three times in 2018.

- **Deferred tax assets had a $1 billion reserve against the in 2017 on the notion that Twitter may not be able to realize these deferred tax assets. Twitter reduced the reserve three times in 2018 which helped it beat forecasts.**

- **In 2019, Twitter transferred intangible assets to its foreign subsidiaries which resulted in a $1.2 billion increase in deferred tax assets.** The foreign operations generate lower revenues than US operations and total operating profits were already starting to decline – yet Twitter did not set up an allowance for these new deferred tax assets.

- **In 2Q20, Twitter took a $1.1 billion charge to establish an allowance against the deferred tax assets. It was already missing forecasts for the quarter and COVID provides cover for many things these days. Y/Y operating profits had already declined at an accelerating rate for four quarters without this allowance rising.**

- **Interesting to note, Twitter noted in its press release and its earnings call that it expects to still use these deferred tax assets in the future. It also reported that it may be able to reverse the allowance which would help earnings.**

- **We consider it a positive that R&D spending has grown significantly in recent years and Twitter is paying for more of it in cash over stock.**

- **We also consider it a positive that Twitter is now investing more in the company via higher capital spending.** Capital spending was coming in below depreciation in 2017.

- **We adjust cash flow for capital leases and see that cash flow has improved significantly until recent COVID pressure on revenue.** Most importantly, we believe Twitter was free cash flow positive in most recent years had it paid all expenses in cash and not used stock as a currency.

Did Twitter Set Up Future Earnings with Deferred Tax Assets?

Watching Twitter's deferred taxes may be the largest changes unrelated to the 2017 tax cuts that we have seen. The company has a large amount of deferred tax assets – largely from tax credits and prior operating losses. Historically, there was a large allowance against these deferred tax assets indicating that management believed it would be unable to realize the full benefits:

	2019	2018	2017
Income tax Exp.	-$1,075.5	-$782.1	$12.6
Net Op Losses	$390.0	$513.4	$720.4
Tax Credits	$425.0	$375.7	$327.8
Fixed Assets/Intangibles	$1,214.1	$24.8	$10.8
Total Deferred Tax Assets	$2,290.0	$1,023.9	$1,152.6
Allowance	-$223.8	-$210.9	-$1,021.3
Net Deferred Tax Assets	$2,066.2	$813.1	$131.3

In 2018, Twitter started to reverse the allowance back into income and allowed income tax expense to become hugely negative:

- 2Q18 the allowance was cut by $42 million reflecting changes in Brazil.
- 3Q18 the allowance was cut by $683 million reflecting higher profitability in the US making it more likely the deferred tax assets would be realized.
- 4Q18 the allowance fell by $120 million based on forward estimates changing and reducing the allowance.

This helped Twitter meet some of its forecasts on EPS, but adjusted for the tax allowance changes – EPS started to miss in 4Q18:

- 2Q18 EPS of $0.17 beat by 1-cent, the adjusted EPS was $0.17
- 3Q18 EPS of $0.21 beat by 7-cents, the adjusted EPS was $0.21
- 4Q18 EPS of $0.31 beat by 7-cents, but the adjusted EPS was only $0.17

In the 2Q19 – Twitter boosted deferred tax assets by transferring many intangible assets to its foreign subsidiaries. Notice that it did not boost the allowance by much after more than doubling the amount of deferred tax assets. In the 2Q19, Twitter earned $1.58 per share which beat by $1.39. However, the adjusted EPS was only $0.05, indicating a sizeable miss.

In 2Q20 – Twitter built a huge allowance against deferred tax assets again. It added $1.1 billion to the allowance based COVID driving losses. The company was expected to post $0.00 for EPS and had a huge loss largely related to this allowance of -$1.56. The adjusted EPS of -$0.16 was in fact a large miss.

There are many signs in our view that this allowance is simply taking advantage of COVID to set up future earnings growth by reversing the allowance going forward.

- In the 2Q20 press release, Twitter said, *"In Q2 2020, we recognized a deferred tax asset valuation allowance of $1.1 billion and a non-cash income tax expense based primarily on cumulative taxable losses driven primarily by COVID-19.* ***This valuation allowance would be reversed in the event, and to the extent, that it is more likely than not that there will be sufficient taxable income to realize the tax benefit****."*

- On the 2Q20 call, Twitter was even clearer, *"Let me also cover a couple of modeling things where you may have questions. You may have also noted a large non-cash loss related to a valuation allowance for a deferred tax asset. This reverses a gain that we took last year. It's related to our ability to use some of our international deferred tax assets in the near future.* ***We're confident that when the current operating environment turns around, we'll eventually be able to use these deferred tax assets.****"*

- The nature of the international business has not changed with COVID if our view. If the reason for a huge allowance against the deferred tax assets is lower profitability – they could have made that same argument in 2Q19 when they transferred these intangible assets to the foreign subsidiaries and established the allowance then.

International usage consistently grows faster than the US. It's not as profitable, but International was 81% of total monetized daily average usage in 2Q20 and the growth is accelerating.

Monetized DAU	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Y/Y US Operations	24%	18%	15%	15%	12%	4%
Y/Y Intl Operations	36%	27%	22%	17%	15%	6%

Twitter has seen operating profits in decline for a year before COVID, and yet did not increase the allowance:

	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Y/Y Op Inc. change	-$199.6	-$101.1	-$54.0	-$47.7	-$3.9	$18.7

R&D Has Increased and Twitter Is Paying for More of It with Cash – Positive

When we first started following Twitter it was cutting R&D spending in absolute dollars and it was boosting the amount paid in stock compensation over cash wages. There has been a solid turn-around in this area to improve reinvesting in the company and earnings quality:

	YTD20	YTD19	2019	2018	2017	2016
R&D Spending	$416	$306	$683	$554	$542	$714
R&D paid in stock	$139	$97	$209	$184	$241	$336
Cash Wage %	67%	68%	69%	67%	56%	53%

Twitter has still not topped 2015's rate of R&D spending of $807 million. At least, it is moving in the right direction for a tech company. Also, Twitter boosted spending in 2020 even as revenues declined as customers pulled back on advertising spending. That is crimping EPS, but Twitter is catching up on underinvestment in our view.

Twitter Has Invested in New PP&E and Is Not Using Capital Leases - Positive

We said in late 2018: "We will note that Twitter has no equipment that is depreciated longer than 5-years. Net PP&E was actually falling! We believe Twitter's capital spending will need to continue rising and may exceed $500 million going forward to deal with growth, normal replacement, plus two years of under-investment."

The company has now seen capital spending rise to levels that exceed depreciation again:

	YTD20	YTD19	2019	2018	2017	2016
Depreciation	n/a	n/a	$449	$407	$349	$333
Capital Spending + Cap Leases	$287	$219	$541	$484	$284	$319
Cap Leases	$0	$0	$0	$16	$123	$100

Capital leases inflate free cash flow because only the interest expense lowers net income, which inflated cash from operations with the principal payment in the financing section of cash flow. Also, new equipment on capital lease is not listed as capital spending so the free cash flow figure is inflated via a lower capital spending number. In 2016 and 2017, the amount of equipment acquired this way was a significant amount of the total, and Twitter was still spending less than actual deprecation. We consider it a positive that capital spending has now topped depreciation for 2.5 years and there are no new capital lease issues.

The Cash Flow Statement Looks Much Better Too – Positive

In prior years, Twitter was a cash eating machine. That was even before adjusting for the capital lease accounting. It was extremely dependent on using stock to pay for normally cash items such as wages and acquisitions. Until 2018, if Twitter had to pay cash – it would have reported negative free cash flow or basically zero free cash flow. COVID has resulted in 2020 seeing this reverse due to declining revenue. This could reverse as advertising recovers. As noted earlier, the monetized daily average usage trends have accelerated its growth during COVID.

BTN Adj Cash Flow	YTD20	YTD19	2019	2018	2017	2016	2015
Cash from Ops	$448	$691	$1,303	$1,340	$831	$763	$383
Less Principal on Cap. Leases	$17	$38	$67	$90	$103	$101	$118
Adj. Cash from Ops	$431	$653	$1,237	$1,250	$728	$663	$266
Less Capital Spending	$287	$219	$541	$484	$161	$219	$347
Plus Sales of Equipment	$4	$3	$6	$13	$3	$0	$0
Less Cap. Lease Purchases	$0	$0	$0	$16	$123	$100	$31
Less Cash Acquisitions	$34	$20	$30	$34	$1	$167	$62
BTN Adj. Free Cash Flow	**$114**	**$417**	**$671**	**$729**	**$446**	**$177**	**-$175**
Wages paid in Stock	$231	$178	$378	$326	$434	$615	$682
Acquisitions paid in Stock	$1	$0	$0	$19	$0	$1	$517
Total Stock Payments	**$232**	**$178**	**$378**	**$345**	**$434**	**$617**	**$1,199**

Looking at cash flow, the legacy of capital leases is having a smaller impact. Comparing the adjusted free cash flow figures to the total spent via stock, the free cash flow exceeds the stock total. So, Twitter could go to 100% cash payments and not result in negative free cash flow anymore. The exception is 2020, where there is a legitimate excuse.

Keurig Dr. Pepper (KDP) 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 at 2- (Weak)

The 2Q20 results still show a great number of the negative issues we have been pointing out. KDP reports that its adjusted EPS of $0.33 beat by 1-cent. We think the company picked up in excess of 2 cents from cutting marketing and not having lease costs from recent sale-leaseback transactions in the quarter. In the real world, Latin America had a disastrous quarter with sales down 15% and operating income down 19% - but KDP adjusted its way into 1.4% sales growth and a 30% growth in operating income for the quarter. We think they picked up some EPS there too:

- **Accounts Payable at $3.38 billion are higher again vs. 1Q.** Cost of Sales rose considerably in 2Q (up 9.8% y/y on a 1.8% increase in sales), which lowers the DSPs for payables from the record high of 254.5 days to the second-highest level now of 236.7 days. **If we adjust the COGS for COVID items and a common Mark-to-Market item that KDP adds back, DSPs were 245.9 days. KDP still pulled in $139 million in cash flow by stretching the payable figure in dollar terms in 2Q. That is 21% of their operating cash flow in the quarter.**

- **This is a company that touts its free cash flow. It has been obvious that stretching payables has been a key to the company reporting higher cash flow.** It was 21% of operating cash flow in 2Q20, 15% in 1Q20, 35% in 2019. **They also leave out finance lease payments, which hit in the financing section, not the operations section**. That inflated free cash flow by $24 million in 2020 so far **and KDP adds back asset sales**

as part of free cash flow which was $202 million in 2020 so far. Adjusting for just these items – Free cash flow of $988 million falls to $561 million.

- **KDP also helped its cash flow with two other items that are not quantified. The company noted that it reduced marketing in the quarter.** In 2019, marketing was $670 million or 6.0% of sales. It shows up in SG&A – which in the 2Q, fell in dollar terms on KDP's adjusted figures from $913 million to $836 million y/y. We think a drop in marketing spending was a big part of this improvement that will return in future quarters. Marketing grew in 2019 and was growing in 1Q20 too. **Every 1% of sales that marketing declined was worth $28.6 million in 2Q20 – or 1.6-cents in EPS**. **Sales incentives/rebates are another form of marketing that show up as a reduction in sales. In 2019, KDP said a 10% change would be $36 million.** It is possible KDP picked up some earnings there too. KDP called out lower marketing as a reason for operating margin gains for 3 of the 4 units.

- **We have been pointing out that KDP has not been paying down debt as much as it is moving to new forms of debt that are not counted as leverage in traditional measures such as payables and operating leases. The asset sales KDP has been making are basically sale lease-back transactions.** We found the following note in the 1Q20 10-Q:

  *"As of March 31, 2020, the Company has entered into leases that have not yet commenced with estimated aggregated future lease payments of approximately $610 million. **These leases are expected to commence between the second quarter of 2020 and second quarter of 2021**, with initial lease terms ranging from 7 years to 20 years."*

  Thus, there were operating lease payments that were not hitting in 2Q20 – that are likely about $10-$15 million per quarter. That added to cash flow too and on EPS – another 0.6-0.8 cents for the quarter.

- **We do not buy that KDP's debt figure is down to 4.0x adjusted EBITDA. There is $2.3 billion in payables that could unwind on KDP if its debt rating falls. There are new lease obligations of over $1 billion.** And KDP still owes $182 on structured payable they exclude from the debt total. **That would add $3.5 billion to the debt total and make the Debt/adjusted EBITDA ratio 5.0x.** The company's 4.0x figure also ignores that the bulk of the debt is only guaranteed by the Dr. Pepper assets and cashflow and that is only half the company. That inflates the effective Debt/EBITDA figure considerably too.

- As we warned, KDP lost their pricing power. For the company, volume was up 4.3% with pricing down 1.4%.

2Q20	Volume	Price	FX	Net
Coffee	8.3%	-2.5%	-0.4%	5.4%
Packaged Bev	6.6%	-0.3%	-0.1%	6.2%
Bev Concentrate	-11.4%	-4.8%	-0.3%	-16.5%
Latin America	-4.7%	6.1%	-16.3%	-14.9%

- **Latin America spun as an improving business?** We know inflation and devaluing currency issues cloud the Latin American results. **KDP is touting that sales growth was actually 1.4%, not -14.9% due to its prowess in taking pricing and ignoring the FX hit.** Does anyone really believe this is a growing business? Volume was down 4.7% on top of a negative volume figure of 1.4% in 2Q19. Then, is a 6.1% pricing gain coming because people are clamoring for product or because the FX loss was 240% greater than the price hike? On income, Latin American operations declined from $26 million to $21 million due to FX impacts and lower volume and that $21 million was helped by cutting marketing and restructuring. To get to the figure KDP is touting that on an adjusted basis, income grew from $20 million to $26 million on a constant currency basis they had to do the following:
    - Add back $3 million in FX hits in the quarter
    - Subtract $6 million in items from 2Q19 income – none of which are specified. The only language is that 2Q19 income declined from 2Q18 primarily due to a $5 million rebate paid by a supplier in 2018 and that 2Q19 was hurt by higher inflation.
    - Add back $2 million more to 2Q20 results – none of which are specified either. Restructuring costs sound like part of it.

We would consider FX to be part of life with that division and would not give them credit for $3 million there. We also would view the marketing decline as something unlikely to be sustained. Plus, 2Q19 sounds like an easy comp to begin with for this unit. $3 or $4 million is not even a rounding error for EPS so we would focus more on this situation as a symptom of KDP's aggressively defined "adjusted EPS."

- Adjustments to EPS at KDP go beyond most other companies we look at. Several companies don't add back restructuring or FX impacts. For 2Q20, GAAP EPS of $0.21 was raised by almost 60% to $0.33 by adding back 10-items. Those 10-items did not include calling out the size of the marketing cuts, the size of the cuts in travel/entertainment, or the delayed lease expense. We give KDP low marks for overall earnings quality on several points:

    - Stock option expense is a recurring item – they add it back
    - KDP records basically zero cost of an acquisition beyond interest expense (and it adds that back to EBITDA too). It only amortizes a small part of the acquired assets and adds back that expense along with all restructuring and integration expenses. It's as though the company doubles in size for free.
    - Mark to Market changes for inventory, restructuring, and legal bills occur regularly and are also added back. Restructuring and Productivity charges, in particular, are material and can include a number of ongoing expenses too such as training, updating software, maintenance, management time, meeting changing regulatory rules, etc.
    - FX has a real cost here – by ignoring it – KDP is touting that a unit with negative volume growth and huge declines in sales is actually growing.

Unum Group (UNM) 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

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

We are raising our quality rating to 2+ (Weak) indicating improvement

This is a fairly recent report, so we will just update on some key near-term risks and urge readers to use the April 17, 2020 EQ report for more detail on some of the accounting rule changes and insurance company structure changes that may impact UNM. Our initial rating on UNM focused on four primary risks:

- A holding company structure that sees the bulk of parent cash flow coming from dividends paid by subs. There are many legal limitations on dividends from the subs and the structure may need to change.

- Much tighter cash flow at the parent company level to cover cash payments to reinsurance companies, dividends, and stock repurchases. Cash flow has not covered this outflow for years and Unum has borrowed the difference.

- Issues with the investment portfolio such as investments in energy and transportation bonds, long-duration making interest rate swings, and credit spreads having more pronounced impacts and owning direct mortgage loans in retail.

- The Long-Term Care unit having more issues with reserve levels and new accounting rules that may require more frequent updating of assumptions and capital requirements.

Some of this situation has improved for the better:

- Holding company parent is more liquid at the moment with $1.55 billion in cash at the end of June after issuing $500 million of debt in 2Q20.
    - It has already paid two dividends and half its interest expense for the year – It will still have payments of just over $200 million for the 2nd half of 2020.
    - It is not buying shares back at this time – which saves about $400 million in cash based on historical spending levels.
    - Payments for capital to reinsurance subsidiaries are expected to be about $600 million this year - $150 million has been paid – leaving $450 million.
    - There is a bond maturity payment of $400 million in September and no other maturities until 2024.
    - Adding that up, it's $1.05 billion in cash outflow for the 2nd half against $1.55 billion in cash plus additional dividends from subsidiaries that it should receive.

- The structure here is still complex in our view and that puts limits on subsidiaries sending cash up to the parent via dividends – however, we don't see a COVID issue
    - UNUM has reported some higher claims in short-term disability, but not beyond what was expected.
    - Some mortality claims for COVID are up – but that is being offset by lower mortality due to other causes.
    - Persistency is down for some insurance lines but not by a material amount as could have happened with so many offices closed.
    - We are not seeing big signs that the operating subs are being strained.

- The investment book saw a rally in the 2Q with oil prices recovering and the credit spreads tightening again
    - The energy part of the portfolio is $4.45 billion or 9% with $2.15 billion as mid-stream bonds. Independent Oil & Gas is $1.16 billion or 2% of the total portfolio. Energy rallied back from $3.73 billion in valuation at the end of 1Q.
    - Unum cut its expected problem forecast from $1.6 billion in downgrades to $1.3 billion and $85 million in forecasted to defaults to $70 million.
    - It is not out of the woods yet with transportation at 5% of the portfolio or $2.4 billion and some of that may take longer to recover.
    - Also, we would still be concerned about the direct mortgage loans to retail properties.

  - From first quarter, the portfolio grew from $45.3 billion to $48.2 billion. Realized losses of $144 million in 1Q became gains of $34 million in 2Q. Unrealized gains rose $963 million in 2Q too.
  - The bigger issue may remain putting new money to work at earning a high enough return at this point.

- The Long-Term Is Still a Cash Drain
  - Funding the reinsurance company dealing with this issue is a major part of the cash outflow to subs by the parent company discussed above for $600 million.
  - That annual cash outflow is not expected to peak for many years still.
  - Unum has warned that the capital requirements for the reinsurance company may be raised by regulators, which could mean even more capital toward this area.

General Mills (GIS) EQ Update- 5/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3-

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

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

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We are raising our earnings quality rating to 3+ (Minor Concern) from 3- (Minor Concern)

- We have previously cited GIS's rising inventory levels which management most recently blamed on building a cushion for labor contract negotiations. Heading out of the 11/19 quarter, the company had promised to normalize inventory levels which was expected to compress margins in the second half of the fiscal year ended 5/20. However, COVID-related demand accelerated the decline in inventory in the 5/20 quarter leading to an almost 10-day YOY decline in DSIs to 42 which reduces our concern level.

- GIS's cash flow continues to benefit from rising payables. DPOs rose to almost 98 days from just over 96 a year ago. Management admitted in the 10-K that the payables increase was partially due to "continued extension of payment terms." This is now our key area of concern and the only issue keeping us from raising the rating to a 4 (Acceptable).

- Impairment testing showed that the fair value of the $330 million in Progresso intangible assets was only 5% above carrying value while the Europe and Australia segment intangibles maintained a 14% cushion leaving open the possibility of further write-downs in these assets.

Kimberly-Clark (KMB) EQ Update- 6/20 Qtr

Current EQ Rating*	Previous EQ Rating
3-	3-

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

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

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We maintain our earnings quality rating of 3- (Minor Concern)

- On the surface, inventory DSIs in the 6/20 quarter rose by 4 days over the year-ago quarter. However, this is an example of how simply looking at the result of a ratio can be misleading. Inventory balances fell by 1.6% YOY yet sales increased slightly. However, the DSI calculation utilizes cost of sales which fell by $273 million. Some of this decline was due to larger restructuring charges last year. After adjustment for that, the DSI increase fell to 3.7 days. However, cost of sales also benefitted from $80 million in lower commodities costs (primarily pulp) and significant costs savings from its FORCE and restructuring programs. While we don't know the exact impact on cost of sales, it was obviously significant. Therefore, we are not concerned by the elevated headline DSI increase. In fact, management indicated it was working to rebuild inventories to meet demand in the next quarter.

- Our biggest concern regarding KMB is the ongoing restructuring charges which have been approximately 10% of non-GAAP earnings for the last several quarters. This period has not been an exception as new programs have emerged every couple of years and we are skeptical that the current program will be the last. As noted above, cost savings have been a significant boost to results with total cost savings in the 6/20 quarter reportedly amounting to $175 million. However, large charges always carry the potential for operational expenses to be lumped in and dismissed by analysts.

- In addition, we have previously flagged KMB for low advertising expense versus its peers which the company is currently correcting by ramping up its promotional spending. This is expected to increase further in the second half of the year with plans calling for more than 60 bps of sales increase in spending.

Fastenal (FAST) EQ Update- 6/20 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)

We see FAST's reporting as being of high quality. Our original rating was based on deteriorating working capital ratios which reflected changes in the company's market and strategy. While the improvement in these ratios in the 6/20 quarter was admittedly artificial, we are nonetheless taking the opportunity to upgrade our rating to 4+ (Acceptable). We remind clients that our earnings quality ratings do not consider valuation or macro factors. Several questions are facing FAST in the short run including how quickly manufacturing will rebound and how much of their recent surge in safety-related products will become permanent.

- Our original rating of 3+ (Minor Concern) partly reflected the fact that FAST's larger customers were becoming a bigger part of FAST's sales mix and were pushing for extended payment terms. This resulted in rising receivable DSOs and pressure on cash flow growth. However, DSOs were essentially flat in the 12/19 quarter, rose a day in the 3/20 quarter, and declined 1.4 days in the 6/20 quarter. Management indicated that $75 million of the YOY increase in receivables was due to COVID demand and it expects those to be collected in 3Q. We would not read too much into the DSO decline in the quarter as it was largely the result of the elevated sales and not an indication of a sudden improvement in collections. However, we have never seen the company's rise in receivables as an artificial boost to sales growth, but rather a shift to larger customers that the company cannot control. We note that any sustained shift in safety sales to a new customer base could result in an overall improvement in collections.

- On the subject of receivables, FAST's accounts receivable allowances fell as a percentage of gross receivables to 1.3% from 1.4% in the previous several quarters. The allowance percentage was in the 2% range two years ago. We are not concerned about this given that it would take less than a penny per share to boost the allowance back to 2%. Also, like sales, receivables are due from larger national accounts with onsite locations which are conceivably better credit risks.

- Our other red flag for FAST was rising inventory balances to support its expanding onsite locations. Headline DSI in the 6/20 quarter fell by more than 16 days versus last year. However, the DSI ratio was distorted by a jump in cost of sales driven by a shift to lower margin safety products, lower safety margins from last-minute outsourcing to meet demand, increased rebates, and deleveraging of fixed costs. The 240 bps drop in gross margin was more than offset at the operating line by a reduction of costs, but the unusually high cost of sales deflated the DSI calculation. If conditions normalize in the next few quarters, we would not be surprised to see a slight increase in DSIs driven by the expansion of onsite locations for larger corporate accounts. Still, we are going to use this as an opportunity to raise our earnings quality rating to a 4+ (Acceptable) given that the trend towards rising DSI is indicative of a business strategy and not the unexcepted buildup of product.

- On a non-earnings quality-related matter, we had to pass along this piece of wisdom voiced by CEO Dan Florness in the conference call:

  "The other suggestion I gave to the folks… was maybe shut off the TV and get off social media. There's more garbage there than value, unfortunately. Talk to each other, talk to your customer, solve problems. That's the task of the day."

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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