BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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LyondellBasell Industries (LYB) 2Q20 Update Maintain BUY

We are maintaining our BUY recommendation on LYB after it missed 2Q20 forecasts by 1-cent on depressed earnings caused by large drops in volume. The overriding long-term advantages have all returned at this point and this company should see earnings and cash flow recover going forward – with some headwinds in 3Q.

- US natural gas liquid feedstocks have a cost advantage over foreign oil-based chemical feedstocks.

  "When naphtha-based [oil-based] costs became favored during March and April, some speculated that the curve would have remained inverted, and eliminating the U.S. shale gas advantage. ***As economies began reopening during May and June, the***

cost curve quickly began slow and reasserted the advantage of Middle East and North American feedstocks*.*

North America has an abundance of ethane and other natural gas liquid resources*. While events may occasionally depressed oil prices, and temporarily invert the cost curve,* ***we continue to believe that North American producers will typically have advantage for the foreseeable future."***

Also, in the call, LYB noted that there are still 500,000 barrels of ethane being rejected at this point in the US as supply exceeds demand, and wells that were drilled and not fully completed early this year are starting to come online.

- China is the higher-cost producer and the incremental source of demand – and pricing for products is rising again. Inventories in the channel are at 5-year lows.

- LYB is seeing volumes return and retaining COVID related volumes for medical items and single-use bags along with more packaging. The biggest laggard was auto-related products where production has now resumed. LYB expects to operate key facilities at 90%-95% of capacity in 3Q vs. about 75% in 2Q.

- Volumes are also key to producing more co-products that are sold at high margin. Having the production rate increase 20-percentage points should help those earnings to return.

- 20%-25% of the business is tied to fuel usage which is picking up and should be one of the faster businesses to recover.

- LYB is committed to its dividend of $350 million/quarter and continues to have sizeable liquidity of $5.8 billion. Capital spending is expected to be lower in 2020 and 2021. Its largest growth project will delay its completion from 3Q21 to 3Q22.

There are still some negatives to sort through in the coming quarters:

- A big part of cash flow in the 1Q and 2Q came from falling feedstock prices and running at lower volumes. That released a sizeable amount of working capital into cash flow as higher-priced inventory and receivables were replaced with lower levels of cheaper product:

LYB Cash Flow	2Q20	1Q20
Cash from Ops	$1,292	$542
Chg. from A/R	$483	$4
Chg. from Inv.	$342	$121
Chg. from A/P	-$250	-$235
Chg. in Other	$280	-$356
Work Cap Chg.	$855	-$466

So, $1.3 billion in cash from operations in 2Q looks impressive, but two-thirds came from releasing cash from working capital. We would expect that as volumes are increased again, selling prices are increased, and feedstock prices have bounced off the lows that working capital will need to be rebuilt.

Also, LYB noted that the income figure will have some transition too with volumes higher, but feedstock costs rising faster than price increases take hold – which could crimp operating margins in 3Q.

- Hedges also helped cash flow in 2Q. While not part of operating cash flow, LYB entered new hedges in 1Q that cost $238 million, while in 2Q, they exited others that resulted in $346 million in cash payments. Derivatives also added $91 million to operating income in 2Q in sales and COGS vs. -$12 million in 1Q. That seems likely to reverse in 3Q and 4Q so that creates and earnings headwind too.

Starwood Property Trust (STWD)- 2Q'20 Update Maintain BUY

We maintain our Buy recommendation after 2Q results that beat forecasts by 2-cents with core EPS of $0.43. Core adds back gains/losses and non-cash items like depreciation and allowances. We again came away with the belief that STWD focuses heavily on safety and liquidity to be able to not only survive turmoil, but to take advantage of it. We believe STWD will maintain the dividend as the company is a REIT, profitable on both a GAAP and Core basis, the dividend at $0.48 or $135 million per quarter is sustainable given current liquidity and reducing it by 5-10 cents would not result in meaningful cash preservation. Also, one of the major negatives of having so much liquidity and reduced leverage is their balance sheet was a drag on EPS. Barry Sternlicht noted this prominently on the call too:

> *"So it's a choppy road, and we have to be careful. We're here for the long haul. We're not here to have a one quarter. I didn't mention, I should have mentioned that I had in my notes, but you're sitting on $800 million of cash you $600 million of excess cash is at 10% yield, which we've obviously done better in all our business lines and that is $60 million. It's $0.20 a share in earnings. So, you can add $0.20 to our earnings for a normal period for us once we put the capital to work. But we can't do that. However, we can cover the dividend because we have all these gains in our books."*

The fortress balance sheet would appear to have STWD in a good position to see earnings rise going forward and we are going to point to a number of areas where STWD's future is being put in place:

- **One reason they are hoarding so much cash is they have a $500 million maturity of senior notes in November and they will leave the FHLB membership in February where they owe $342 million.** STWD plans to refinance the notes with another bond, however, they are holding the cash on hand in case the market tanks again and closes to reasonable financing deals before they refinance the notes. They already retired two-thirds of the FHLB borrowings and have $1 billion in new bank lines closing in the coming weeks that should be available to cover both debt issues.

- **On balance sheet debt was reduced to only 2.0 times equity in 2Q**. They have unencumbered assets of 1.5x debt as well. The decision was made in the quarter to

not only bolster liquidity but also move more debt off-balance sheet largely with securitizations. Total debt with the securitizations and A-notes is 3.2x equity. The goal is to finance about half the business off the balance sheet so there remains meaningful ability to make deals. STWD has $9.5 billion in borrowing capacity available, over $800 million in cash, and still has $2.9 billion in assets it could put liens against if needed. As we have discussed many times, STWD has interest rate floors of 157bp on $6.2 billion of its floating rate loans – those are in the money and help EPS as rates decline. They could sell some of those floors for cash too. The key for them is they have options to take advantage of mispriced opportunities and many competitors do not.

- **STWD also discussed that is rebuilding its pipeline for more deals. STWD noted that the list of deals they are looking at is about as long as pre-COVID times. Normally there is a fair amount of cash being returned in every quarter via principal payments and borrowers refinancing or selling their property and repaying the loan to STWD. They may be going too far on conservatism by forecasting that less than 4% of their loans will be repaid in 2H20** and that very low rate will last in 2021. That is the other reason they are making sure they have the ability to fund new deals without relying on repayments. The goal was also to reduce future funding obligations on existing deals. With the securitizations, they cut the future funding needs to 35% of 1Q's ending figure. President, Jeff DiModica addressed this too, *"For liquidity planning purposes, we conservatively extended management's expected loan repayment dates, and are now modeling that less than 4% of our loan book repaid in the second half of 2020, as well as significantly less in 2021 than we previously forecasted. Given less loans could pay off in the coming 18 months, we actively reduced our future funding requirements in the quarter to be sure we can easily cover those fundings in cash if no loans are repaid, which is a very draconian assumption that I'm sure we will be wrong on."*

- **Looking for evidence that most of these markets have seen recovery, STWD noted that 98% of interest was collected last month. Some of the remaining 2% was temporarily delayed due to COVID-related modifications that were being completed.** They have seen a few modifications that were very short-term in nature and came with more equity being infused by the sponsors of the deal. On the worst-performing sector – hotels – they have seen $150 million in new equity put into those deals with another $150 million coming in 2020. Also, 20% of its hotel loans are to extended-stay hotels that have had 80% occupancy during COVID. STWD noted that no assets

had to be added to non-accruals or justified a specific bad debt reserve. The new CECL accounting rules that use a modeling forecast based on macro factors did add $11 million to total reserves. One of the great stories of 2Q was STWD bought several deals of non-qualified residential mortgages with low LTV and high FICO scores at significant discounts. During 2Q, it securitized a large number of them at par and the mark-to-market hit in that unit in 1Q was essentially reversed back in 2Q. It had two Winn Dixie warehouse properties it had reserves against and leased both to Amazon and Dollar General and they are now valued at a gain to STWD's cost.

- **Areas where future earnings may arrive that were immaterial in 2Q include the balance sheet inefficiency described in the introduction. It also includes the Special Servicing unit** that sees business pick up in distressed times and it gained $2.8 billion in new business in the quarter with $8 billion actively being worked on. They get paid when deals are resolved and STWD believes many of these will take a longer time – so there should eventually be EPS coming from this area. The Energy Infrastructure portfolio is also not operating as efficiently as it could as STWD kept a large staff there and has not made new loans. The ultimate goal is to do a CLO with some of these loans and that will require adding some more deals. They do not want commodity exposure so we doubt they will finance drillers, but midstream and power plants are possible. STWD could see this area drive some EPS growth at some point.

- **While not part of Core Earnings – Mark to Market hits of 53-cents in 1Q become 15-cents in income in 2Q. Also, CECL triggered a 17-cent high in 1Q and another 15-cents in 2Q.** Given that the bulk of the loan book is first mortgages with an LTV of under 61% we see few reasons to expect many losses in the book CECL headwinds may mitigate. STWD also lost 1-cent from core EPS when it refinanced its multi-family property and had a charge for extinguishment of debt.

- **There continue to be many examples of assets on STWD's books that are carried below fair market value.** In the 2Q, STWD refinanced some of its multifamily properties again, they pulled another $100 million out and cut their cash investment from $169 million to $30 million. They bought these at a 6.16% cap rate and occupancy has stayed very high and rents have risen at more than 2x the expected rate at acquisition. The refinancing included an appraisal of the property at a 4.64% cap rate. So, this is throwing off considerable cash flow on a small cash investment

that has appreciated. STWD also pointed to huge gun sales helping its Cabela's investment. They sold a North Carolina office property for a gain in 2Q and a $10 million gain selling a minority stake in a real estate advisory firm that was part of a 2016 transaction. Finally, in discussing real estate's valuation Barry Sternlicht made some strong points. One was - in a world starved for yield, people are buying Amazon bonds to earn 30bp – while STWD is first-tier AMZN creditor too getting paid 500bp.

Book value is $15.79 and the stock trades below that now with a 13% yield. Simply adding back the depreciation on the property that has appreciated in value makes book value $17.03. Management estimates there is another $2.67 per share of unrealized gains at STWD which makes book value $19.70.

Snap-on Inc. (SNA) 2Q'20 Update
Maintain SELL

We maintain our SELL rating on SNA.

- The percentage of past-due contract receivables (credit franchisees) fell to 0.76% at the end of the 6/20 quarter from 0.83% a year ago and 0.90% in the 3/20 quarter. However, this was artificially enhanced by the company extending low-interest rate loans to help out its franchisees. We estimate that the past-due percentage would have doubled to about 1.9% of the portfolio if just 25% of the low-interest loan amount had gone past due. SNA has a history of supporting its franchisees in tough times which is admittedly good business practice. This may work out well in the long run assuming miles driven does bounce back above historical trend with people shifting from flying, cabs, and ride-sharing and back towards driving their own cars.

- Past due finance receivables (credit to franchisees' customers) as a percentage of the portfolio fell to 1.74% from 2.53% in the year-ago quarter and 2.98% in the 3/20 quarter. However, collections fell to $167 million from $192 million in the year-ago quarter as the company allowed some customers to delay their payments. Loans on forbearance rose to 2.5% of the portfolio at the end of the quarter compared to a historical norm of 1%. We estimate if these amounts had been allowed to be marked as past due, the past due percentage would have risen to 3.25%.

- As noted above, helping out customers in times of trouble makes sense. However, one of our biggest concerns is the stability of its small auto shop customers who have been taking a beating for years as the market shifts to dealerships, larger chain shops, and now towards electric cars. We again remind clients that the yield on the company's finance receivables is over 17%- these are already not financially healthy customers. We will continue to watch for signs that they are having trouble getting current on loans over the next couple of quarters.

Contract Receivables

Contract receivables are loans made to franchisees for equipment and working capital. On the surface, credit metrics improved significantly in the quarter:

Contract Receivables	6/27/2020	3/28/2020	12/28/2019	09/28/2019
30-59 days past due	0.25%	0.39%	0.32%	0.33%
60-90 days past due	0.15%	0.20%	0.19%	0.22%
>90 days past due	0.36%	0.31%	0.32%	0.35%
Total past due	0.76%	0.90%	0.84%	0.90%
>90 Days and Still Accruing	0.06%	0.09%	0.11%	0.04%

Contract Receivables	06/29/2019	03/30/2019	12/29/2018	09/29/2018
30-59 days past due	0.29%	0.29%	0.38%	0.40%
60-90 days past due	0.23%	0.20%	0.27%	0.31%
>90 days past due	0.32%	0.32%	1.16%	0.85%
Total past due	0.83%	0.81%	1.81%	1.56%
>90 Days and Still Accruing	0.07%	0.09%	0.04%	0.04%

However, these figures benefitted artificially from the company issuing approximately $20 million in low-interest loans to franchisees to support their businesses through COVID. This resulted in contract receivables originations increasing by more than 20% in the period and also drove down the average yield on the portfolio to 8.2% from 9.1%. The company has a history of supporting its franchisees during tough times which makes good business sense. For perspective, however, if we assume the $20 million in low-interest loans were not made, and just 25% of that amount became past due, it would have driven the past-due rate on the contract receivables portfolio to about 1.9%, double the rate seen in the year-ago quarter. Miles driven are expected to rebound and even rise above historical trend as people avoid flying, cabs, and ride-sharing due to the virus. If this happens, we may see business at local repair shops pick up and franchisees may be able to service this debt. However, investors should be watchful for signs that the COVID impact permanently impaired an already stressed small repair shop customer base.

Finance Receivables

Finance receivables represent mostly loans made to franchisee customers. As with contract receivables, the headline credit numbers in the finance showed significant improvement in the quarter:

Finance Receivables	6/27/2020	3/28/2020	12/28/2019	9/28/2019
30-59 days past due	0.55%	1.07%	1.16%	1.07%
60-90 days past due	0.29%	0.68%	0.71%	0.67%
>90 days past due	0.90%	1.23%	1.26%	1.19%
Total past due	1.74%	2.98%	3.13%	2.92%
>90 Days and Still Accruing	0.70%	0.97%	1.01%	0.93%

Finance Receivables	6/29/2019	3/30/2019	12/29/2018	9/29/2018
30-59 days past due	0.95%	0.85%	1.17%	1.08%
60-90 days past due	0.61%	0.58%	0.73%	0.74%
>90 days past due	0.97%	1.17%	1.23%	1.19%
Total past due	2.53%	2.60%	3.13%	3.00%
>90 Days and Still Accruing	0.75%	0.90%	0.96%	0.94%

However, these numbers also saw an artificial benefit in the period. Finance receivable originations declined by 8.5% in the quarter. However, consider the following quote from the conference call:

> *"Collections of finance receivables in the quarter of $166.8 million compared to collections of $191.6 million during the second quarter of 2019. This year's quarter reflected the* ***greater use of deferred payment plan sales programs and short-term payment relief or forbearance to some of our franchisees qualifying customers.***
>
> *Similar to the trends elsewhere in our business, we saw the greatest number of requests for payment relief on extended credit or finance receivables in April. This lessened in May, and* ***as of the end of June, forbearance was granted for approximately 2.5% of the portfolio. Historically, those accounts having forbearance terms are below 1% of the finance receivable portfolio."***

So, the company avoided marking loans as delinquent by modifying the payment terms and allowing franchisee customers to put off making payments until later. Again, this may prove to be good business in the long term if miles driven bounce above the historical trend and customers can catch up on their payments in upcoming quarters. But to again put this in perspective, past due finance receivables were $30 million at the end of the 6/20 quarter. If we assume that the incremental 1.5% of the portfolio placed in forbearance at the end of the quarter compared to the historical norm had been allowed to be marked as delinquent, we estimate it would have almost doubled the past-due balance to 3.25% of the portfolio versus last years second-quarter level of 2.5%.

Ares Capital Corp (ARCC)- 2Q'20 Update
Maintain BUY

We are maintaining our BUY recommendation on ARCC as the worst of Covid lockdowns on the portfolio appear to be over and ARCC remains committed to its dividend of $0.40/quarter. Core EPS of $0.39 beat by 1-cent. Core EPS excludes gains/losses both realized and unrealized and incentive fees related to the realized and unrealized gains/losses. Core EPS in 1Q20 was $0.41 but also suffered from significant mark-downs in portfolio values. In 2Q, the portfolio value rebounded. There are still some questions outstanding, but we believe the worst has been seen and the 11% yield is tough to ignore. We believe the dividend will hold as there is enough liquidity to sustain it and ARCC is simply not very far from out-earning it again in a short period of time:

- Largest negative issue is variable rate investments with LIBOR going down. This is reducing interest income:

ARCC Stats	2Q20	1Q20	2Q19
Avg. Portfolio	$15,177	$15,093	$13,416
Interest Income	$213	$232	$228
Avg. Yield	8.1%	8.4%	9.4%

  ARCC has 84% floating rate investments and 79% of those have floors of 1.1% on them so the rate of decline should be largely contained at this point. Interest expense is declining too but not at the same rate. From 1Q to 2Q, interest expense fell $6 million. That is a function of having a diversified balance sheet on the funding side with many fixed rate medium term notes rather than relying heavily on short-term variable rate financing. We consider that a positive for ARCC as it prevents liquidity issues.

- ARCC is also reducing leverage. This is a function of more investments being repaid than new ones originated and also paying down some debt. So that is both good and bad:

ARCC Stats	2Q20	1Q20	2Q19
New Commitments	$867	$1,272	$1,307
Exits	$1,484	$918	$1,348
Net Debt/Equity	1.08	1.19	0.77

We understand why at the moment ARCC is not making a huge number of new investments. However, what makes this work longer-term is pushing the leverage ratio up with more investments. This will need to change.

- The largest positive is it appears the bottom was reached for investments in the quarter and the recovery has begun. There are several signs of this. After the unrealized net loss of $846 million in 1Q20, 2Q20 saw $112 million of unrealized net gains. The sponsors for several of the weaker performing investments have injected new equity in the deals. ARCC has tightened credit terms for several of the deals. The level of drawn revolvers ARCC has for investments has also declined, indicating liquidity issues have abated:

ARCC Stats	2Q20	1Q20	2Q19
Revolver Available	$1,945	$2,083	$2,009
Revolver Drawn	$685	$921	$460

- Supporting the dividend is the goal for ARCC and they are not far from it. They posted core EPS only 1-cent below the dividend. They still have $0.96 per share of spill-over income – prior gains earned – that must be paid out to keep ARCC's tax-exempt status. The debt to equity figure is below the company's goal, which should also boost income in the future. There are no debt maturities in 2020 or 2021 and there is still a significant amount of both investment income and repayments that flows through ARCC. Net investment income in 2Q was essentially equal to the dividend $170 million and the company tends to see about $1 billion per quarter of principal repayments. So income needs to improve with more investments, but the liquidity is here to sustain the dividend as the CEO said on the call, *"I'll reiterate from our call last quarter, the balance sheet is in great shape, with our consistent earnings, strong balance sheet, in our portfolio positioning, we felt highly confident in declaring a $0.40 per share quarterly cash dividend for the third quarter of 2020, and we believe that we can continue to support a steady dividend level for the foreseeable future."*

- The non-accruals rose in 2Q to 4.4%. We only see two companies (restaurants) marked to zero, which we would expect. Several of the remaining ones on the surface appear to have COVID business disruptions and may recover with time – three are dental-related, one is pharmaceutical, and one rents equipment. In some of those cases, the company is still paying first-lien debt but not second-lien. ARCC noted that additional equity has been infused by the parent company of several investments and the modifications it has made to loans are largely short-term such as deferring interest, changing some interest to PIK, etc. On the surface, the non-accruals do not seem packed with companies we would expect to see in dire straits. Some of these could recover. ARCC noted on the call that because it works with many of its investments for long periods of time, they understand them and the management well. Over its lifetime, ARCC has realized about $1 billion in gains with 25% coming from companies that needed modifications. This is worth watching, but about 70% of the non-accruals may see recoveries in our view.

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

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

We maintain our earnings quality rating at 2- (Weak)

After cutting guidance after 1Q20, RP beat reduced forecasts handily by 8-cents. More importantly, the company pulled up its bottom guidance but did not raise the top forecasts and expects EPS to be lower in both 3Q and 4Q following 2Q's results. We continue to see several areas of poor-quality earnings again at RP. The biggest red flag is the difference between GAAP EPS and adjusted EPS ($0.11 vs $0.49). On the surface this is getting wider:

RealPage EPS	2Q20	2Q19	1Q20	1Q19	4Q19	4Q18	3Q19	3Q18
GAAP EPS	$0.11	$0.16	$0.06	$0.12	$0.21	$0.07	$0.12	$0.09
Adj. EPS	$0.49	$0.43	$0.43	$0.40	$0.48	$0.39	$0.45	$0.38
Adjustments	$0.38	$0.27	$0.37	$0.28	$0.27	$0.32	$0.33	$0.29

- After 1Q20, RP cut 2Q adjusted guidance to 38-42 cents – saying the following:
  - "*Adjusted-EBITDA is expected to be $66 million to $70 million, which represents margins of 24% to 25%. **Our second quarter adjusted-EBITDA is expected to be impacted by over $3 million** of spend that we incurred to ensure not only that we are ready to respond during the COVID-19, but also that we went above and beyond for our customers*"
  - "*While we intend to adjust variable costs due to lower revenue and the realization of some productivity improvements, **we do not expect to reduce product development or sales and marketing spend** given our view that clients*

will have an increased need for products and services that help them accelerate their transition to more virtual operations."

- In 2Q20 results, the first thing RP said was that COVID Costs were not as large as expected and for several reasons this was a positive surprise:

  "***Numbers were exceptionally good relative to guidance because the impact of COVID-19 was not as impactful as we had feared*** *and there is surging demand for solutions that facilitate virtual leasing and living offered by RealPage."*

  "Margin performance was driven by continued investments for growth and included incremental expense related to RealPage adapting to the COVID-19 environment. Despite these incremental costs, ***we were able to ramp down some COVID-19 costs faster than anticipated."***
  "we also received some uplift from reduced COVID-19-related costs, such as travel and employee and medical benefits as many procedures were restricted."

- From our reading of this - **$3 million in COVID costs would cut adjusted EPS by 2.3 cents.** RP does not quantify the difference from having these costs vanish more quickly or the unexpected windfall of having less travel expenses or employee medical costs. **If this change was $1 million below guidance, they picked up 0.8 cents in EPS here. It also seems more likely that employee medical** costs will become a headwind in 3Q and 4Q as procedures are likely being done now.

- **Also, after giving guidance that 2Q would not see a reduction in sales and marketing or product development – RP saw both expenses decline:**

RealPage EPS	2Q20	1Q20
Product Development	$31.4	$31.5
Stock Comp.	$1.6	$1.9
Adj. Product Dev.	$29.8	$29.6
Sales & Marketing	$49.4	$54.7
Stock Comp.	$2.3	$5.9
Adj. Sales & Marketing	$47.1	$48.8

In the adjusted EPS, RP adds back stock compensation as though that is a one-time optional expense that occurs every quarter. That is one area where we always point to RP's

adjusted EPS being aggressive. However, as RP guided to rising expense and always adds back the stock compensation we will look at from that angle. **Both adjusted costs fell as a percentage of sales. Product Development fell from 10.70% to 10.44% – that added 0.6 cents to adjusted EPS. Sales and Marketing fell from 17.63% to 16.50% - that added 2.4 cents to adjusted EPS.**

- **Our next item to question is what looks like some big-bath charges that appeared with COVID.** The company has made over 45 acquisitions, including some large ones in 2017. While RP either doesn't amortize and/or adds back essentially every cost of a deal – there has not been a much history of taking large legal or restructuring charges:

Last 5 years	2019	2018	2017	2016	2015
Org. Realignment	$1.53	$0.00	$0.00	$0.00	$0.00
Regulatory/Legal	$1.47	$0.08	$11.01	$0.00	$0.00

There were no realignment charges called out until 2019. RP describes these as charges to exit bad contracts, severance pay, closing facilities, and professional fees. Regulatory and Legal costs pop up for Hart Scott Rodino reviews of large acquisitions or settlement of other one-time matters such as in 2017. But, look at the last 8 quarters:

Last 8 Qtrs	2Q20	2Q19	1Q20	1Q19	4Q19	4Q18	3Q19	3Q18
Org. Realignment	**$1.22**	$0.00	**$1.21**	$0.00	$0.83	$0.00	$0.68	$0.00
Regulatory/Legal	**$2.15**	$0.35	$0.36	$0.00	$0.90	$0.00	$0.22	$0.08

We have seen enough restructuring charges to know that they normally involve a big charge upfront and get smaller over time. Here – the first charges are smaller and the quarters with COVID when people are less concerned about every penny, they get larger. Also, RP guided that this charge would be $350,000 in 2Q as the quarter was already a month done and finished at $1.2 million. Given that RP uses this process to clean up poor contracts or assign some third-party fees or management time devoted to restructuring – the growing charges look aggressive to be added back. To the extent these remove future costs like for a low margin contract these help boost future earnings and adding them back boosts current earnings too. If they include items like training or management time – those are recurring expenses in our view. **The alignment charges added 0.9 cents to adjusted EPS**.

There was no discussion or reason given for the surge in legal bills in 2Q20. Guidance was for this to be zero in 2Q. The company does say that it accrues for legal items and we saw accrued expenses rise from $87.3 million to $98.6 million in the quarter. To the extent, this is for legal settlements or bills to pay overtime, this looks a large figure that will reduce future costs and is being added back now to current earnings too. Legal bills are normally about $350,000, **we are going to highlight the additional $1.8 million in 2Q20 as a potentially a lower-quality source of EPS that added 1.4 cents to the results.**

- **Finally, RP also rounded up its Adjusted EPS by 0.4-cents, which brings the total to 6.5-cents with lower COVID, reductions to R&D and marketing, a surge in realignment costs and legal costs. And, the company began the quarter cutting forecasts from likely a range of 45-50 cents to 38-42 cents.**

- **Other red flags appear for future guidance too:**
    - **RP did not raise its top forecasts after the big 2Q beat.** 3Q is expected to be 43-46 cents and 4Q 42-46 cents. Total 2020 guidance went from $1.95-$2.00 down to $1.74-1.84 in 1Q. After beating by 8-cents in 2Q, only the low-end moved and 2020 guidance is now $1.77-$1.84.
    - **Further evidence that the realignment and legal accrual in 2Q may have been big-bath charges that help reduce future expenses is also seen in guidance.** Realignment charges are expected to fall to only $750,000 in 3Q and under $300,000 in 4Q. Legal is expected to come in at zero.

Church & Dwight (CHD) 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)

- Accounts receivable DSOs in the 6/20 quarter fell by 6 days versus the year-ago period. This follows a similar YOY decline posted in the 3/20 quarter. Management attributed the decline in receivables to "sales timing and increased receivable factoring." We have criticized the company in the past for its minimal disclosure regarding its receivables factoring program. CHD discloses only the amount of receivables factored on an annual basis and does not reveal outstanding factored balances at the end of the period. This makes it impossible to calculate a DSO adjusted for receivables that have been factored but not collected at the end of the quarter. The concern in such a situation is that accelerated factoring is masking an increase in DSOs. We do not believe that is the case in the 6/20 quarter given the magnitude of the DSO decline, but the situation warrants continued scrutiny going forward and lowers the quality of the company's reported results.

- Inventory DSIs rose by 4 days YOY in the 6/20 quarter. This follows an almost 6-day YOY decline in the 3/20 quarter driven by the initial COVID pantry-stuffing wave. The company has experienced strong demand for laundry and cleaning products, cat litter, baking products, and gummy vitamins have gone from the problem child of the portfolio to superstar growth-driver overnight. At the same time, personal products such as WATERPIK and condoms have experienced strong declines. While management did not address the buildup of inventories in the 10-Q or the conference call, it did indicate that inventory levels at retailers had normalized. Management also has indicated that it expects its cleaning and wellness brands, gummy vitamins

included, to be at a new permanent plateau. This makes us wonder if the buildup in inventory was a combination of expectations for second-quarter sales as well as unsold WATERPIK and condoms. To the extent it is the latter, we would expect DSIs to wind back down in the second half. We will become more concerned about the inventory levels if the increase continues into 3Q.

- CHD warned investors in the 10-Q that the *TROJAN* condom tradename ($176.4 million) was "susceptible to impairment risk" due to recent declines in sales and profits. However, as of the 12/19 quarter, fair value exceeded carrying value by 26%. This is a fairly big buffer and the COVID-related hit to demand should decline in upcoming quarters. However, it is worth noting that the company has also warned that competition has increased and the category has seen secular growth pressures. The 10-Q states "Condom usage has declined, as a result of a lower 18 to 24-year old population, alternate birth control options, less fear of HIV, decreased sexual activity, and increased competition, all of which have contributed to lower demand for our products in the condom category." These long-term secular trends pose more of a worry that the company could eventually face a write-down in the *TROJAN* intangibles. Also remember that prior to the COVID boost, the company was warning that the gummy vitamin category was vulnerable to a write-down, so if the company's permanent plateau of demand for its vitamin products does not materialize, we could be seeing those warnings again.

- Given the artificially strong demand in the 6/20 quarter, the company cut advertising and promotional spending which was a 180 bps boost to operating margins. The company expects this to reverse in the back half as conditions normalize and to support new product introductions. For reference, the decline in marketing expense as a percentage of revenue added about 6.5 cps to earnings growth in the quarter.

Cintas (CTAS) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	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

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

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

CTAS reported adjusted EPS of $1.35 in the 5/20 quarter which was 13 cps ahead of consensus estimates. However, we identified about 16 cps in likely one-time benefits to earnings in the period along with other items worth noting.

- CTAS capitalizes certain commission costs to obtain contracts. We estimate that the amount of costs deferred jumped by more than 20% YOY despite a 10% decline in sales in the same period. Costs that are deemed to be "incremental to obtaining the route servicing customer contract" are deferred which appears to give management discretion in deciding which costs are capitalized. If management became more aggressive in capitalizing costs in the quarter, it would have artificially boosted earnings. We estimate if the amount of capitalized costs as a percentage of sales had remained the same, it would have shaved over 4 cps off EPS in the quarter.

- Stock compensation expense declined in the 5/20 quarter, adding over 10 cps to earnings in the period.

- The effective tax rate fell to 20.4% from 21.7% which added 2 cps to earnings in the quarter.

- Accounts receivable DSOs at the end of the 5/20 quarter jumped to 49.4, a 2.8-day increase versus the year-ago quarter. CTAS noted in the 10-K that it reevaluated its allowance for bad debts given the impact of COVID on its customers which resulted

in the company boosting the allowance to 6.7% of gross receivables from 4.0% last year. DSOs calculated on a gross basis (which adjusts for the increase in the reserve) rose by more than 4 days. This is not overly alarming given that revenue fell by almost 10% in the quarter. CTAS's fourth quarter ended on 5/31, so revenue was not participating in much of the upside in reopenings. After adding back the increase in allowance, receivables fell by about 2%. We suspect this is an indication of delayed payments more than the company luring in revenue with payment terms. We will view another increase in DSOs in the first fiscal quarter with skepticism, as we will a noticeable takedown in the allowance percentage.

- Inventory DSIs rose by 9.5 days over the year-ago quarter largely centered in the Uniform Direct Sales segment. CTAS increased the allowance for obsolete inventories to 10% of gross inventory balances from the high 8% range of the previous few quarters. It is worth noting the company stated in the 10-K that "once a specific inventory item is written down to the lower of cost or net realizable value, a new cost basis has been established, and that inventory item cannot subsequently be marked up. The concern here is that the company will be able to utilize this inventory in the event of a recovery and profits will be artificially boosted from the new lower cost basis.

Increase in Deferred Commissions

Since the adoption of ASC 606 in 2018, CTAS has capitalized its commission costs to obtain contracts and amortized them on a straight-line basis over the expected period of benefit. CTAS discloses the balance of deferred commissions as well as the periodic amortization costs. We calculate an estimated amount of commissions capitalized in each quarter as a plug number shown in the table below:

	5/31/2020	2/29/2020	11/30/2019	8/31/2019
Beginning Deferred Commission Balance	$295.8	$290.9	$283.3	$275.6
Amortization of Deferred Commissions	$20.1	$19.7	$19.2	$18.8
Estimated Commissions Deferred (PLUG)	**$27.6**	$24.6	$26.8	$26.5
Ending Deferred Commission Balance	$303.3	$295.8	$290.9	$283.3
Sales	$1,619.6	$1,810.6	$1,843.7	$1,811.1
Commissions Deferred at Previous % of Sales	1.70%	1.36%	1.45%	1.46%

	5/31/2019	2/28/2019	11/30/2018
Beginning Deferred Commission Balance	$271.7	$266.7	$259.7
Amortization of Deferred Commissions	$18.4	$18.0	$17.6
Estimated Commissions Deferred (PLUG)	$22.3	$23.0	$24.6
Ending Deferred Commission Balance	$275.6	$271.7	$266.7
Sales	$1,793.7	$1,682.3	$1,718.3
Commissions Deferred at Previous % of Sales	1.24%	1.37%	1.43%

Despite a near-10% YOY decline in revenue in the 5/20 quarter, the estimated amount of commissions deferred rose by over 20% YOY and over 10% sequentially. We would have expected the company to significantly throttle back its efforts to get new accounts in the middle of COVID shutdowns, yet deferred commission costs jumped. Note that the company explains in its 10-K that commissions are deferred when they are "deemed to be incremental for obtaining the route servicing customer contract" which seems to give management some wiggle room in determining which costs are "incremental." If costs were aggressively deferred, it would have artificially benefitted results in the quarter. We estimate if the rate of capitalization as a percentage of sales had remained consistent with last year, it would have cost the company a little over 4 cps in earnings in the quarter.

Explanation of EQ Rating Scale

Rating	Description
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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