BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Mondelez International (MDLZ) 2Q'20 Update
Maintain SELL

We maintain our SELL recommendation on MDLZ as the company may not maintain the COVID-related strength in sales or cash flow. The company's adjusted EPS beat forecasts by 7-cents. It picked up 5-cents from reversing an allowance against Chinese tax loss-carryforwards:

From the 10-Q:

> *"Our second quarter effective tax rate was 12.1% reflecting a discrete net tax benefit of $72 million. The discrete net tax benefit primarily consisted of a $70 million net benefit from the release of a valuation allowance in China as we now expect to utilize prior-year carryforward tax benefits to offset future taxable income."*

The company did not quantify it, but reported it spent less on advertising and promotional expense in its international markets and for the company overall. It had pension expense decline by $28 million y/y or 1.5-cents in the quarter. If the lower advertising was more than a $9 million impact, the 7-cent beat is basically gone. Advertising is a $1.2 billion annual expense for MDLZ historically.

- **North American Volume was not as amazing as 1Q despite having a much longer period of the lockdown, an easy comp, and Easter.** Management noted that the pantry-stocking is essentially over but has seen continued sell-through of products.

North Am	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18	2Q18
Price	3.6%	1.2%	1.9%	1.9%	3.5%	2.0%	2.9%	1.2%	0.6%
Vol/Mix	7.4%	12.1%	1.2%	0.6%	-1.0%	-1.5%	-2.1%	-3.2%	5.1%

They are out of easy comps on volume at this point. And even with all the COVID tailwinds that lasted longer than two-weeks in 1Q20, volume growth declined by 470bp.

It is also worth noting that biscuit sales for the company were up 11% and in North America up 24% in 2Q. Biscuits are 80%-90% of North American sales. MDLZ noted several times on the call that biscuit sales are heavily tied to people staying at home. With restrictions easing more and schools restarting in many places, this could become a headwind.

- **Latin American Pricing continues to skew reported organic growth.** Because MDLZ reports its growth rate as the net change of only price + volume and ignores FX – it is still essentially denying the reason Latin America was able to take price hikes in the first place and Latin America is the largest part of pricing:

2Q20 Sales Growth	Price	Vol	Organic	FX	Actual
Latin Am	7.5%	-18.3%	-11.3%	-19.4%	-30.7%
Emerg. Mrks	2.7%	-7.8%	-5.1%	-9.7%	-14.8%
All MDLZ	2.0%	-1.3%	0.7%	-4.6%	-3.9%

The actual results are adjusted for acquisitions and divestitures. Latin America had the largest gain in pricing but lost more than twice of that total to negative FX impacts. The entire company reported growth from pricing of 2.0% which is $121.2 million. Latin America's 7.5% amounted to $55.3 million or nearly half the total increase. Latin America is the smallest unit at less than 9% of sales. Removing it from the mix cuts the full company's pricing gain from 2.0% to 1.2%. Plus, the growing losses at Latin America also point to how unrealistic the strong pricing figure before FX hits are in the reported organic growth. Latin America operating income fell from $70 million adjusted for a $2 million VAT settlement in 2019 to -$6 million in 2Q20. That further supports the notion that the strong pricing figure is not showing a healthy market with strong demand allowing price hikes.

- **Stretching working capital was a big source of cash flow for 2Q20.** Given some of the market disruptions around the world and one-quarter does not make a trend – we are going to say, this is something to watch in 3Q and 4Q.

MDLZ Wrk Cap	2Q20	1Q20	4Q19	3Q19
Days Payable	139.3	119.1	128.6	126.5
Days Inventory	69.1	52.3	55.9	65.2
Days Receivables	30.6	35.8	29.2	35.8
Days Receivables Sold	10.6	11.4	10.0	10.7

MDLZ Wrk Cap	2Q19	1Q19	4Q18	3Q18
Days Payable	134.9	128.7	125.2	126.6
Days Inventory	69.4	60.6	56.0	66.9
Days Receivables	32.8	38.8	30.5	33.7
Days Receivables Sold	10.7	11.3	11.0	11.2

Inventory dropping so much at the end of 1Q20 makes sense as COVID hit and started the panic buying. Also, remember that MDLZ's balance sheet receivables exclude receivables that it sells to help cash flow. That overall level has not moved much in the last two years. However, when looking at cash flow so far in 2020 vs. 2019 – 2Q had a huge boost from working capital:

MDLZ Cash Flow	2Q20	2Q19	1Q20	1Q19
Cash from Operations	$1,274	$581	$284	$465
Cash from Working Cap.	$624	-$355	-$740	-$743
Cash flow before W/C	$650	$936	$1,024	$1,208

The reason we are pointing to this is MDLZ is giving guidance to expect inventory levels to increase going forward and payables may not be able to increase at the same rate. This may cause a headwind for cash flow:

> *"As it relates to the trade, if anything, **I would say that the trade inventories at the moment are low because it has been difficult to keep up with demand**. We significantly have reduced our assortment of SKUs just to provide a good customer*

*service. And so if anything, **<u>I would say as our demand would slowdown a little bit, that will give us an opportunity to bring the trade stocks back in line with where they should be</u>**. So from my perspective, I feel pretty strong, certainly about Q3 and Q4 in U.S., I don't really expect, it might slowdown a little bit, but we're still in high single-digit growth rates, to my opinion, which is much better than it was in the past."*

Three points to make here: The SKU reduction was pointed out as 25% of SKUs but only about 2% of sales. Also, the inventory growth is expected to come from filling the channel – that would give MDLZ a one-time boost in sales. However, that type of growth can vanish very quickly because it isn't necessarily matched by sell-through to the consumer. Third, while gum was hurt by people staying at home and biscuit sales drove the recent results which MDLZ pointed out on the call several times are heavily tied to people staying home – gum is only about 7% of sales and biscuits are about half. As people get out of the house losing biscuit sales to gum is a drag. Also, does the trade want to carry COVID-level stocks if consumer sell-through slows? This could back up on MDLZ in the form of higher DSIs on its balance sheet and that could become an area for a sales disappointment if DSIs rise rather than being recorded as sales to the trade channel.

- **MDLZ is still taking more pricing based on raw material cost increases – but the spread is getting much smaller.** In our view, this is an area that has not been sustainable given how much buying power the retail channel has after consolidating into several very large customers. Wal-Mart, Kroger, Target, Safeway, Costco – those companies all follow the inflation numbers too. COVID had an impact on the volume figures, but look at some of the components for pricing vs. raw material costs on operating income:

Op Income	2Q20	2Q19	2Q18
Pricing	$120	$180	$84
Input Costs	-$102	-$116	-$18
Volume	-$60	$35	$43

In 2019, pricing exceeds input cost inflation by $236 million in operating income, and in 2018 it was $296 million. They are not getting the same level of increase in 2020. This may become a headwind as these differences tend to even out.

- **MDLZ continues to outspend its free cash flow.**

Cash Flow	1H20	1H19	2019	2018	2017
Cash from Ops	$1,558	$1,046	$3,965	$3,948	$2,593
Capital Exp.	$445	$465	$925	$1,095	$1,014
Free Cash Flow	$1,113	$581	$3,040	$2,853	$1,579
Acquisitions	$1,141	$0	$284	$528	$0
Dividends	$819	$756	$1,542	$1,359	$1,198
Repurchases	$720	$940	$1,480	$2,020	$2,174
Total spent	$2,680	$1,696	$3,306	$3,907	$3,372
Total % FCF	240.8%	291.9%	108.8%	136.9%	213.6%

Recent acquisitions lost money – Give & Go reported a -$8 million loss for 2Q20. Debt is now $18.1 billion up from $15.5 billion at the end of 2016. Adjusted Operating Income + Depreciation/Amortization is now $5.1 billion (or $5.3 billion for 2019 if you want to exclude COVID). So, debt/EBITDA is 3.4-3.6x. Their share repurchases are getting smaller while the share count is down 8.5% or 134 million shares since 2016. It should be down 12%, but MDLZ also issued 55 million shares to management during that same time.

The basic conclusions are MDLZ is touting that it expects FX to be less of a headwind in 2020 than they guided to after 1Q. The negative 4-5% hit to revenue is now expected to be 3% and the EPS hit of 10-cents is expected to be 5-cents. **It also thinks it will see COVID-related spending decline from $100+ million in 2Q which hurt EPS by 7-cents. Then, it will continue to hold on to the higher sales growth as the channel restocks.**

We disagree on several points:

- 100% of COVID costs may not disappear in the coming quarters and they already offset much of COVID expenses by reversing the tax allowance, which shouldn't repeat either.
- MDLZ has also said it will need to see marketing and advertising increase again. They spend $1.2 billion per year on that plus whatever they record as reductions to sales for rebates, incentives, and other trade promotion to help retailers. That is simply a larger number and a 5% move is more than $60 million.
- Recent growth was helped by a surge in biscuit sales that will be tough to maintain in our view. The dynamics that created that surge are waning now and 2Q did not hold 1Q's level of surge. Picking up gum again is unlikely to offset the much larger biscuit sales unit if that slows.

- Recent growth has been fueled by pricing exceeding raw material headwinds. That source of growth is shrinking and may become a drag especially if the sales growth is going to be driven by stocking the channel and not as much from consumer sell-through.

We also want to point out that we have some serious issues with Keurig Dr. Pepper (KDP), which MDLZ owns a 13.1% stake worth about $5.6 billion. We believe that a sizeable part of KDP's recent cash flow has come from stretching payables to as long as over 250 days. Also, we disagree that KDP has been retiring debt as it has simply refinanced it into areas like payables, leases, and a structured payable. None of those items are viewed as financed debt. So, cash flow is overstated and the debt is being understated in our view. It may also face slowing sales as people return to work and drink less pod coffee and canned soda at home.

Sealed Air (SEE)- 2Q20 Update
Maintain SELL

We maintain our SELL rating on SEE. We believe there is actual negative growth rather than the company's non-GAAP 3% growth that includes acquisitions and no FX impacts. **The company beat forecasts handily in 2Q20, but the forecast for a negative Price/Cost spread didn't happen.** The positive Price/Cost issue added 8-cents to EPS in 2Q20 and forecasts coming into 2020 were for $70 million in negative or 33-cents of drag in the first half. **On top of that, SEE guided to a -15% figure for 2Q for its protective unit, which came in down 8.6%. It guided to -5%/-6% for food in 2Q and that came in at -0.4%.** Those wildly lowballed forecasts also allowed SEE to beat expectations. A 6% change in protective sales is worth about 2-cents in EPS and a 4% change in food is worth about 4-cents in EPS.

Forecasts for the year of $2.85-$2.95 against $1.49 in the first half do not appear that strong for a company that beat recent forecasts already.

- **Sealed Air's 3% growth figure (rounded up from 2.8%) includes an acquisition and ignores FX headwinds**. We don't consider an acquisition to be organic growth and SEE's history shows that FX is almost always an expense – adjusting for these two items – the growth rate was -7.2% for 2Q20.

- **All of the pricing gain again came from South America which is due to hyperinflation, not market strength. Despite South America accounting for less than 5% of total sales – the price hike here added 0.9% to SEE's organic growth.**

- **Price/Cost is a contracted way for SEE to recover periods of cost inflation from customers. There are quarters where it benefits from this and quarters where it is a headwind – but over time it is expected to net out to zero. In 2019, Price/Cost was an $83 million positive causing the company to guide to -$70 million mostly in the first half of 2020.**

- **Price/Cost actually came in at positive $18 million in 2Q20 adding 8-cents to EPS. Compared to a forecast of headwind in the 9-20 cent range – this was a huge positive swing for 2Q EPS. The negative headwind may still occur in the 2nd half of 2020.**

- **COVID costs only amounted to $5 million as SEE netted it against the lower travel costs and other discretionary cost-cutting.** As COVID wanes, the other costs are expected to return and more than offset COVID savings.

- **Working capital has been helped by factoring receivables. The jump in inventory at the end of 2Q is worth monitoring.**

- **SEE's legal issues continue. It remains under investigation by the SEC regarding its tax accounting, financial reporting, and disclosure.** It has changed the text on its $1.49 billion deduction dispute with the IRS. It used to say this may take years to resolve to "it could have a material impact within the next 12 months." It also has resolved a clawback lawsuit related to its sale of Diversey. It is expected to lose some receivables which would cost as much as 6-cents to EPS. We could not find any discussion or place where there has been a write-off at this point.

Sealed Air's 3% Growth Remains Misleading Due to FX and Acquisitions

The press release touts that growth was 3% compared to GAAP revenue growth of -1%. Given that SEE should have been uniquely positioned to benefit in all areas from COVID with one division focused on food packaging and people ate at home more and huge grocery stores sales and the other division is focused on product packaging that is supposed to be enjoying the online e-commerce tailwind – they are debating 3% vs -1% growth?

The first problem is SEE is adding back the FX hit its adjusted growth rate. Then it has an acquisition that drove results from negative to positive:

Rev. Adjustments	2Q20
Price	0.6%
Volume	-4.2%
Organic Growth	-3.6%
Acquisitions	6.4%
SEE's figure	2.8%
FX	-3.6%
GAAP figure	-0.8%

As we have reported for some time, FX hits are a recurring cost of doing business for SEE. With the exception of 2017 when FX helped sales by 0.7%, the company routinely sees FX cut sales by about 3% from the years 2015-2020. That is a big reason why in past years, SEE has reported organic growth of 3%-5% and sales are still basically flat over that time. In fact, on the call, SEE raised its currency headwind outlook for 2020 from $8 million to $25 million.

Then 2020 has an acquisition that helped too along with 2019 and 2018 sales. We have noted in the past that management bonus targets are tied to figures that include sales growth from acquisitions and remove all acquisition costs such as interest expense on debt, amortization, and restructuring costs. However, they could buy a company with declining sales and it would still boost the growth rate for SEE. We consider that very low-quality growth. We would argue that the starting point for sales growth would be – price + volume + FX. On that formula, SEE's revenue growth has been abysmal for a company with two macro tailwinds (people eating more fresh protein and people buying more products via e-commerce).

Rev. Growth	1H20	2019	2018	2017	2016	2015
Price	0.1%	0.9%	3.0%	0.2%	0.6%	2.3%
Volume	-1.2%	-0.9%	1.5%	4.5%	0.6%	0.5%
Organic Growth	-1.1%	0.0%	4.5%	4.7%	1.2%	2.8%
FX	-3.1%	-2.9%	-1.0%	0.7%	-3.4%	-9.9%
Actual Growth	-4.2%	-2.9%	3.5%	5.4%	-2.2%	-7.1%

South America Is Also Inflating the Company's Growth Rate

In our view, SEE's actual growth in 2Q20 is more like -7.2% vs. the company's reported 2.8%. That's only adjusting for acquired sales and treating FX as a recurring item. However, South America still inflates its 2.8% figure even more.

At only 4.8% of sales, South America produced the entire company's price increase in the quarter.

2Q20 rev growth	North Am	EMEA	APAC	South Am	Total
Price in $	-$1.5	-$0.7	-$0.6	$10.6	$7.8
FX in $	-$9.3	-$8.1	-$5.8	-$18.7	-$41.9

This was essentially the case in 2019 also when South American pricing rose by $49.4 million and total pricing rose by $42.5 million. We know this is due to hyperinflation in Argentina. It is not a sign that SEE is able to take pricing which they are not getting anywhere else in the world. The FX hit that more than wipes out the South American price hikes also shows this.

If we eliminate the price hike and let SEE continue to ignore FX, its reported 2.8% figure for 2Q20 falls by 90bp to 1.9%. And that is still helped with 6.4% from acquisitions. On our calculation, removing South America's price increase, the acquisition, and adjusting for FX – the 2Q20 growth rate was -8.1%.

Price/Cost Spread Helped 2Q Earnings Too

One of the big windfalls that helped 2019 was the ability of SEE to push through pricing that exceeded the increase in raw material costs. This was adding about $20 million per quarter in 2019. However, as the company noted in the discussion and its guidance for 2020 – this process is designed to net out to zero over time. It was forecasting that the price/cost spread would turn negative in 2020 for a $70 million headwind mostly seen in the first half. COVID issues seem to have disrupted that forecast.

In 1Q20, Price/Cost was still a positive at $8 million. In 2Q20, it came in at a positive $18 million. For 2Q, this added 8-cents to EPS. However, considering expectations were for a $20-$40 million headwind – this is actually a 17-28 cent swing in results. This can explain the EPS beat, and growth in EBITDA margins from 20.4% to 22.6% actually came in at 21.5% without the $18 million of price/cost benefit.

We think it is also worth noting that COVID was only a $5 million drag in 2Q. It netted the COVID costs with the benefits of lower travel costs and tighter expense control to reach the $5 million figure. The company also noted that as COVID costs decrease – it expects those other discretionary costs to return and offset the savings.

Factoring Receivables Is Helping Working Capital

The company has had securitization programs for receivables in the US and Europe for some time. Since the very end of 2018, it has had a factoring program too. The biggest difference is the securitizations move the receivables to prepaid expenses. Factoring removes them from the balance sheet.

Since this started, SEE has been factoring about $100 million in receivables per quarter:

Working Cap	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
US Securitz.	$0.0	$0.0	$0.0	$60.0	$0.0	$0.0
Eur. Securitz.	$49.5	$74.3	$0.0	$77.6	$78.5	$75.0
Factored A/R	$108.2	$113.8	$105.2	$88.7	$84.5	$72.9

Receivables on the balance sheet reflect these moves. Recent increases in inventory are more of the cause for working capital increasing in the last quarter.

Working Cap	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Trade Rec.	$515.8	$491.5	$556.5	$449.0	$485.2	$464.0
Inventory	$638.2	$568.2	$570.3	$618.3	$596.1	$597.4
Prepaid	$103.1	$133.9	$58.9	$201.4	$127.4	$127.8
less Payables	$724.1	$715.3	$738.5	$712.7	$753.0	$769.1
Working Cap	$533.0	$478.3	$447.2	$556.0	$455.7	$420.1

Sealed Air's Legal Issues are Changing

We have been pointing out that SEE has a potential $525 million tax issue with the IRS. **It is interesting to see that the company changed the language from the 10-K that it may take several years to resolve this to saying in the 10-Q that it could have a material impact for earnings and cash flow within 12 months:**

2019 10-K:

> "W*e are currently under examination by the IRS with respect to the deduction of the approximately $1.49 billion for the 2014 taxable year for the payments made pursuant to the Settlement agreement and the reduction of our U.S. federal tax liability by approximately $525 million. The IRS has proposed to disallow, as deductible expense, the entirety of the $1.49 billion settlement payments. Although we believe that we have meritorious defenses to the proposed disallowance and are protesting it with the IRS,* ***this matter could take several years to resolve and there***

__can be no assurance that it will be resolved in the Company's favor.__ An unfavorable resolution of this matter could have a material adverse effect on our consolidated financial condition and results of operations, including cash flows.

2Q20 10-Q:

"We are currently under examination by the IRS with respect to the deduction of the approximately $1.49 billion for the 2014 taxable year for the settlement payments made pursuant to the Settlement agreement and the reduction of our U.S. federal tax liability by approximately $525 million. The IRS has proposed to disallow, as a deductible expense, the entirety of the $1.49 billion settlement payments. Although we believe that we have meritorious defenses to the proposed disallowance and are protesting it with the IRS, __this matter may not be resolved in 2020. It is possible that future developments in this matter could have a material impact on the uncertain tax position balances and results of operation, including cash flow, within the next 12 months.__

A dispute over a $49.2 million claw back from the sale of Diversey appears to be resolved. However, it cost SEE some receivables too:

2019 10-K:

"In the third quarter of 2019, __the Buyer (of Diversey) submitted a claim to us under the Clawback Agreement seeking such a refund in the amount of $49.2 million.__ In the fourth quarter, we delivered a dispute notice to the Buyer in respect to its claim. We are in discussions with the Buyer, in accordance with the provisions of the Clawback Agreement, in a good faith attempt to resolve this dispute.

__Additionally, Sealed Air has a net receivable balance of $11.6 million included within Other Receivables on our Consolidated Balance Sheets as of December 31, 2019,__ representing amounts owed to Sealed Air from Diversey and/or the Buyer relating to the sale of Diversey or transition services we provided to Diversey after the closing under that certain Transition Service Agreement ("TSA"). This receivable balance includes: income tax receivables related to taxable periods prior to the sale of Diversey; cash held by Diversey in certain non-U.S. jurisdictions as of the sale closing date, which amounts the Buyer must cooperate to deliver to Sealed Air when *and as permitted, subject to certain limitations; and receivables due from Diversey for services performed under the TSA."*

2Q20 10-Q:

> *"On April 29, 2020, Sealed Air and the Buyer entered into a Stipulation and Agreement of Settlement and Release (the "Diversey Settlement Agreement"), whereby, among other things, the Buyer released us from any and all claims under the Clawback Agreement, and the parties terminated the Clawback Agreement.*
>
> *Pursuant to the Diversey Settlement Agreement, the parties settled their disputes relating to certain other Tax Receivables and other receivables arising out of the Diversey sale, including fees owed to Sealed Air from the Buyer pursuant to the Transition Service Agreement entered into in connection with the sale ("TSA") and cash held by Diversey in certain non-U.S. jurisdictions as of the sale closing date that Buyer was required to cooperate to deliver to Sealed Air when and as permitted, subject to certain limitations ("Trapped Cash").* ***<u>Under the Diversey Settlement Agreement, Sealed Air relinquished all of its rights to receive any of the Trapped Cash, and the parties further agreed to release each other from any and all claims arising under or with respect to the TSA, the Trapped Cash, and the Clawback Agreement</u>*** *and such other matters as expressly agreed upon in the Diversey Settlement Agreement (provided, that, except for those specific matters released, the terms of the Purchase Agreement otherwise remain in effect in accordance with their terms)."*

We did not see the actual amount of trapped cash that SEE lost claim to in the 10-Q. We do know that Other Receivables have been declining by $6.0 million from 4Q to 1Q and down another $4.5 million from 1Q to 2Q. The trapped cash figure of $11.6 million in 4Q fell to $1.9 million in 1Q and there was no mention of it for 2Q. SEE adds back recurring legal costs, anytime they hire a consultant, and costs of acquisitions as one-time items. **However, we cannot find anywhere where they wrote off the trapped cash in 1Q or 2Q. Bad debt expense did not rise by an amount that indicates it went there and their adjustments do not note it went into something SEE added back as a one-time event. This could be as much as a 6-cent hit to EPS.**

On the positive side, the US Attorney investigating SEE over the termination of the former CFO and process of its auditor selection has closed its investigation. But the SEC is still investigating the company's tax accounting and financial reporting:

2Q20 10-Q:

> *"The Company has received from the staff of the SEC subpoenas for documents and requests for information in connection with the SEC's previously disclosed investigation. Those subpoenas and requests seek documents and information* ***regarding the Company's accounting for income taxes, its financial reporting and disclosures, the process by which the Company selected its former independent audit firm which audited the fiscal years of 2015 through 2018, the independence of that audit firm, and other matters.***
>
> *Following the announcement on June 20, 2019 that the Company had terminated the employment of William G. Stiehl as Chief Financial Officer, the Company received a Grand Jury subpoena from the United States Attorney's Office for the Western District of North Carolina (the "U.S. Attorney's Office")* ***seeking documents relating to that termination and relating to the process by which the Company selected its former independent audit firm for the fiscal years of 2015 through 2018. The Company has been advised by the U.S. Attorney's Office that it has completed its investigation of these matters and will not be taking any action."***

Macquarie Infrastructure Corp (MIC)- 2Q20 Update Maintain BUY

We are maintaining our Buy recommendation on MIC even after the stock has recovered from $22 to above $30. The basic thesis remains intact that we think the company will unlock its value by selling the operating businesses and we believe the sum of the parts is worth more than $40. MIC's management can earn a $25 million bonus by completing a sale before January 1, 2022.

On the 2Q call, management deflected comments on potential buyers or timing. However, they did say they continue to actively pursue the sale and believed that a sale is likely to be done via several transactions rather than all to one buyer. The IMTT Tank business and the Hawaiian gas utility are more likely to be sold first. The aviation business is starting to recover and seeing volumes increase. However, this is likely the most valuable asset of the three and should command the highest multiple given its history of organic growth. Potential buyers are more likely to want to see how rapidly the recovery plays out and if it is sustained. MIC speculated that if the first two units are sold, they may simply have the aviation unit acquire the parent company and effectively have the cash proceeds from the first two sales and the equity in the aviation business spun out to shareholders.

- **MIC is generating positive EBITDA at all three units and all three produced positive free cash flow in 2Q. The worst may be behind it at this point as IMTT is growing y/y and still seeing strong demand for its tanks and Atlantic Aviation is now at 77% prior levels vs. 21% in April.**

- **The concern in April was that Atlantic Aviation may need external capital from the parent company. MIC now believes this unit will meet its obligations from internally generated cash flow.**

- **Capital spending is still forecast as $60 million for maintenance and $200-$225 million for growth projects. The bulk of both are at IMTT which has seen utilization rates and EBITDA rise y/y. So far, $135 million has been spent in the first half of 2020.** That leaves another $125 million this year. IMTT's free cash flow is at $45-$50 million per quarter. MIC expects to pay for some of the capital spending by drawing down its cash balance and effectively boosting net debt.

- **It is also important to remember that 2021 should also be a heavy year for growth capital spending at IMTT.** The projects have been contracted for and MIC has a set timeline to meet for its customers. Total growth spending at IMTT was forecast at $350 million from 2020-22.

- **A return of the dividend is likely tied more closely to getting the Aviation and Hawaiian Gas units back to more normalized levels.** Hawaii would need to open its state to tourism as much of the gas demand comes from restaurants and hotels. EBITDA is regularly about $60 million per year vs. the current run rate of just under half that figure. Aviation can do $275-$300 million in annual EBITDA but was only $17 million in 2Q. Per management, it has improved noticeably from those levels, but they may want to see this unit performing at closer to $50 million per quarter before they think about paying a dividend again.

- Given the nature of trying to sell the company within the next 17 months, the view may also be that a dividend is simply taking money from one pocket and putting it in the other if they are borrowing money overall. The debt level will be subtracted from the entity value to determine what shareholders receive from a sale. There are 87 million shares here. We doubt MIC brings back the $1 per quarter dividend – but if the other two units have a period of sustained recovery, it would not surprise us to see MIC start paying a small dividend again at the end of 2020.

- A few areas where earnings were helped/hurt in the quarter beyond the obvious loss of business due to COVID:

    - The management fee declined from $7 million to $4 million y/y. This fee is computed based on the market cap of the business which is lower this year. This $3 difference should remain a tailwind until the stock tops $40 again.
    - MIC benefited with other income coming in at $2 million representing some federal grants received to pay for some capital spending.
    - MIC accrued an environmental clean-up liability for the aviation unit of $7 million that lowered earnings.
    - Depreciation should become a headwind going forward as the heavy growth capital spending is completed for a number of projects. Some of these projects are now online with others coming in 3Q and 4Q.

Verisk Analytics (VRSK) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	4+

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

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

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

We are reducing our earnings quality rating to 4- (Acceptable) from 4+ (Acceptable) indicating a minor deterioration in quality

We continue to view VRSK's earnings quality as relatively high quality. The reduction in our rating reflects a mild deterioration from the increase in deferred commissions and a sizeable boost from lower stock-based compensation.

- We noted in our original review of VRSK that it regularly acquires a half dozen or more smaller companies a year. In some years, the company's cash flow does not cover buyback, dividend, and acquisitions. We are usually critical of growth-through-acquisition strategies, but in the case of VRSK, the company is still generating meaningful organic growth without the acquired operations. Understandably, core revenue growth fell to 0.6% in the 6/20 quarter due to the impact of COVID on gaining new business. Acquisitions driving the bulk o the 4% growth in total revenue. Investors should be concerned if core revenue growth does not return to the mid-single-digit range as conditions normalize.

- Deferred commissions rose sequentially in the 6/20 quarter despite a sequential decline in revenue. Over 80% of the company's revenue is locked up under subscriptions and long-term contracts so it did not see a drop in revenue, but it also was clearly not signing up new business in the quarter either. This makes the sequential increase in deferred costs to obtain new contracts look unusual and it a potential indicator of increased aggressiveness in capitalizing costs. If deferred commissions had remained consistent, the balance would have been about $3.5

million (1.7 cps) lower. Given the relatively small amount and the sequential decline in sales from the COVID disruption, we are not assigning a high degree of concern to this, but the development of deferred commissions warrants attention in future quarters.

- Lower stock-based compensation added over 4 cps to earnings in the quarter.

- Core revenue growth in the Energy and Specialized Markets segment was -4.1%. We noted in the original review that this segment accounts for the bulk of intangibles and goodwill and underperformance in that segment increases the possibility of an impairment charge.

A Quick Glance at Core Revenue Growth

We noted in our original review of VRSK that it regularly acquires a half dozen or more smaller companies a year. In some years, the company's cash flow does not cover buyback, dividend, and acquisitions. We are usually critical of growth-through-acquisition strategies, but in the case of VRSK, the company is still generating meaningful organic growth without the acquired operations. However, organic growth has fallen off in the last two quarters which is not unexpected given the impact of COVID:

	6/30/2020	3/31/2020	12/31/2019	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Total Revenue Growth	4.0%	10.4%	10.3%	9.0%	8.5%	7.5%	7.7%
Growth ex-acq./divest.	0.6%	4.8%	5.4%	7.0%	6.4%	5.9%	5.0%

VRSK stated in the 6/20 10-Q that it is not seeing its business fall apart in the current environment as such a large part is already locked in under long-term contracts:

> *"We have analyzed our solutions and services to assess the impact of COVID-19 on our revenue streams. We have not identified any material impact of COVID-19 on approximately 85% of our revenues at this point, as much of these revenues are subscription in nature and subject to long-term contracts. These revenues grew approximately 5% for the three months ended June 30, 2020.*

Of the remaining 15%, we have identified specific solutions and services, largely transactional in nature, that are being impacted by COVID-19. The primary causal factors are lower auto and travel insurance activity, the inability to enter commercial buildings to perform engineering analyses, decreased capital expenditure in the energy sector, and reduced levels of advertising by financial institutions and marketers. The portion of our revenue that is attributable to these solutions has been negatively impacted by COVID-19, and declined approximately 20% for the three months ended June 30, 2020. The deepest impacts were in the categories of travel insurance analytics, auto underwriting and claims analytics in the insurance industry, consulting services in the energy industry, and spend informed analytic solutions in financial services. Although we have experienced a decline in revenue attributable to these specific solutions during the last two weeks of March 2020 and for the three months ended June 30, 2020, currently we do not anticipate lasting impacts of a material nature to our long-term growth profile. As the global outbreak of COVID-19 is still rapidly evolving, management continues to closely monitor its impact on our business."

The 0.6% organic growth in the 6/20 quarter has a reasonable explanation- for now. We will be watching in upcoming quarters to see if organic growth recovers. In our minds, the biggest risk for VRSK is it evolving into the typical growth-though-acquisition story where it is dependent on acquisitions to drive all the growth.

Increase in Deferred Commissions

VRSK capitalizes the costs to obtain certain contracts if it expects the benefit to last longer than one year. The following table shows the balance of these deferred commissions for the last several quarters:

	6/30/2020	3/31/2020	12/31/2019	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Deferred Commissions	$69.2	$66.7	$63.7	$58.5	not disc	not disc	$49.5
Revenue	$678.8	$689.8	$676.8	$652.7	$652.6	$625.0	$613.9
Deferred Commissions Days	9.3	8.8	8.8	8.2	na	na	7.3

The company did not begin disclosing deferred commission balances until the 9/19 quarter so the 6/19 and 3/19 quarters are not available. Note that the deferred commission balance has risen steadily on a sequential basis over the last few quarters assuming the two unavailable quarters were in line with the trend. The company essentially saw no growth in its core business in the quarter, implying there was little in the way of signing up new business. Regardless, the deferred commission balance continued to rise in the 6/20 quarter. If deferred commissions had remained a constant percentage of quarterly sales, they would have been about $3.5 million lower (1.7 cps). If this amount represented the company becoming more aggressive in the capitalization of costs, it could have been a material one-time boost to earnings. Given the relatively small size of the move and the fact that the slowdown in revenue growth in the quarter could have had an impact on the timing of the components, we do not view this as a significant item at this point. Still, this is an area to keep an eye on in upcoming quarters.

Citrix Systems (CTXS) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	4-

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

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

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

We are maintaining our earnings quality rating of 4- (Acceptable)

Despite CTXS soundly beating EPS and revenue estimates in the quarter, the market hammered the stock largely due to a 3% sequential decline in *Citrix Cloud* subscribers. Management noted that this was due to one of its largest customers, a healthcare company, delaying its shift to a cloud model citing other priorities in the current environment. Adjusting for this, management claimed *Citrix Cloud* subscribers rose "modestly". Regardless, we note that annualized recurring subscription revenue rose by 13% sequentially and 55% YOY. We continue to view the company's earnings quality as acceptable and have the following observations about the quarter:

- Deferred revenue days of sales were flat with the year-ago level after several quarters of declines. As we discussed in our original review, deferred revenue at CTXS has been declining despite this fact that the company is shifting to a subscription model which sees revenue paid over time and away from perpetual licenses where the revenue is recognized upfront. This is because maintenance contracts tied to the perpetual licenses are recognized over time and declines in deferred revenue associated with these contracts are offsetting the rise in revenues deferred under new subscription deals. We view this as a positive sign that the progress to the subscription model is progressing.

- In another positive sign, cash from operations rose in each of the last two quarters. Cash flow has been declining as the shift to subscriptions leads to customers paying over time rather than all at once at the beginning of a perpetual license. Management stated at the end of 2019 that the headwind to cash flow growth from the shift to subscriptions was almost gone. While we view the return to positive cash flow growth as a positive, keep in mind that COVID almost certainly accelerated the return to positive cash flow growth by pulling demand into the first half of the year.

- Having noted the positives of stabilized deferred revenue and growing cash flow, investors should be braced for these trends to see some deterioration in the back half of the year. On October 1, CTXS will no longer offer perpetual licenses of its *Citrix Workspace* products that will likely drive an acceleration of subscription license adoptions. Revenue will be recognized over time on these deals with less cash flow received upfront versus the perpetual deals they replace, which will likely increase pressure on cash flow and revenue growth. Management indicated on the conference call that this is reflected in its guidance for the back half of the year, but we could still see this being a source of disappointment, especially when linked with the possibility that COVID-induced demand cools.

- Stock-based compensation increased by 25% or about 17 cps over the year-ago quarter. However, stock-based compensation declined in the 3/20 quarter, so on a trailing six-month basis, it was up only about 7%. However, we note that on a trailing 12-month basis, stock compensation expense has steadily risen to over 9% in the most recent quarter, up from the 5% range in 2017. As we addressed in our original review, this is increasing the distortion of adding back this key expense category to non-GAAP EPS figures. We will continue to watch for a sustained trend in the company paying more compensation expense with stock rather than cash.

- Sales, marketing, and services expense declined due to the cancellation of trips and events due to COVID including the company's largest event of the year. We estimate that if this expense category had remained constant as a percentage of revenue, it would have cost the company over 17 cps in earnings. The timing of this is out of the company's control, but future quarters will certainly be penalized as these important expenses are shifted into the future.

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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