BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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MOWI 2Q20 Update

We are maintaining our BUY rating on MOWI (MHGVY). As expected, pricing remained weak in 2Q due to so many restaurants being closed for COVID which hurt demand. About 40%-45% of salmon is eaten in restaurants worldwide. At-home consumption grew, but in the end, demand in volume rose about 1% worldwide while supply rose 3%. Also, flight cancelations made it difficult to move salmon from its primary production areas like Norway and Chile (where supply grew 10%) to end markets meaning some markets were overly glutted and others under-supplied. We believe as economies reopen, much of this imbalance will correct itself and 2Q represents the worst of the situation. There will be a 3Q headwind as the market needs to work down frozen inventories in Chile.

There are several reasons to again point to long-term fundamentals remaining intact. The growth in MOWI's consumer products has continued to increase despite delaying a marketing campaign in the US as a result of COVID. Long-term demand for salmon should continue to increase as the situation normalizes and there is not a surge of new supply coming. Much of what is needed here is simply to have pricing bounce of multi-year lows.

- **Pricing fell 20%-30% in 2Q20. Closed restaurants and lack of air transport to markets in Asia created additional problems for pricing in other markets that suddenly had to absorb even greater supply.**

- **Demand for salmon still grew as retail sales picked up slack for closed foodservice channels. The 1% global demand growth was met with a 3% increase in supply.**

- **Chile was the big issue where supply grew 10%. It is a supplier to Brazil where retail purchases did not offset closed foodservice options and demand fell 24%. Without Chile, supply and demand may have been more closely balanced.**

- **Falling pricing quickly hurts results. Many costs in salmon farming are fixed and do not change as rapidly. Fish still grow and need to be harvested too. 2Q saw volumes increase at MOWI, which boosted costs overall as farming revenue dropped 14% on lower pricing.** The reverse situation is true during times when pricing increases and fixed costs leverage.

- **Pricing also hurts biomass valuations. This is a recurring non-cash adjustment to the value of growing salmon.** Changes in assumptions for the cost of feed, the costs of health-related treatments, and pricing can raise or lower the biomass valuation. While 1Q had several weeks of very strong pricing that helped actual profits, the steep decline in pricing at the end of the quarter caused a much larger mark-down in biomass valuation than 2Q.

- **Pricing should recover. It has already bounced off the July lows but remains below pre-COVID levels. The forecasts for supply are for growth to decrease in 2H20 and only rise 1% in 2021.** With more foodservice open, demand should also increase.

- **Chile was the source of supply/demand imbalance. It needs to work off frozen inventories that rose in 2Q. However, after a large increase in 2Q harvest, the 2H20 is expected to show much more restrained growth in Chile. Also, new smolt placements that will be next future salmon are down 12% YTD in Chile.**

- **MOWI's liquidity still looks capable of getting the company through the COVID issues. It has no debt maturities for two years. Credit lines and cash on hand are > €650 million. Even using 2Q's impaired EBITDA * 4, the Debt/EBITDA is 2.46x. On a more normalized EBITDA, the ratio is 1.58x.**

- **Even with the steep pricing declines of 2Q, free cash flow was still positive. That also included a sizeable headwind for working capital increases.**

- **Cash needs for 2H20 should be about €110-130 million greater than 1H20. Much of that will occur in 3Q for more working capital build, a tax payment that was deferred from 2Q to 3Q, and €29 million spent to acquire new licenses in Norway. We expect MOWI to have negative free cash flow in 3Q** as pricing dropped further in July before starting to recover. 4Q should see improvements on pricing and lower cash needs and we believe MOWI's liquidity can easily cover a 3Q dip.

- **Consumer products responded well to the lockdowns. The Americas unit had income levels equal to Europe on one-quarter of the sales.** It should continue to grow as MOWI rolls out its delayed marketing blitz. Asia suffered from lack of product due to air transit issues. Europe lost some foodservice sales and also had to absorb higher supply – yet still grew income.

- **Cost reductions are getting more attention.** MOWI already spends heavily annually to emphasize technology to lower costs. Its current goal is to reduce its second-largest cost – labor – by 10% per unit produced. Other ongoing investments in improving salmon health also help lower costs and boost revenue.

- **The 50% JV in DESS may be monetized.** Part of MOWI's past investing in tech created a fleet of well-boats to boost automation, carry live fish, speed harvesting, and produce fresh water that can help mitigate sea lice. With salmon farming volumes increasing, demand for well-boats has been rising too. MOWI may unlock some cash from this investment and is exploring that possibility.

Salmon Pricing Dropped Noticeably in All Markets in 2Q as Expected

MOWI produces salmon in six areas of the world. The major reference prices all showed a steep decline for salmon prices y/y in 2Q20:

Salmon Ref. Prices	2Q20	decline
Norway	€5.24	-19%
Chile	€3.73	-34%
North Am.	€4.49	-27%

There are several reasons for this – most notably that restaurants and foodservice normally account for 40%-45% of total salmon purchases. Many of those businesses were closed during parts of 2Q. Toward the end of 2Q and into 3Q, more restaurants have reopened which should help demand.

In addition, airlines reduced flights on many international routes or canceled service completely. The salmon are raised in areas with relatively small populations such as Norway, Chile, Scotland, Canada, Ireland, and the Faroe Islands. The consumption of salmon occurs in the U.S., China, Japan, Russia, Brazil, and Continental Europe. Getting shipments from Canada to the US or Norway to Europe is not a major issue. However, out of Chile to the US or Brazil had issues. From the UK and Norway to Russia or China certainly was. If you look at the y/y changes in volumes to specific markets – you can see the COVID issues of closed restaurants and where air transportation was spotty.

Salmon Demand y/y Chg	2Q20	1Q20	4Q19
EU	2.7%	2.1%	6.4%
Russia	-18.2%	7.3%	-8.6%
US	2.8%	5.2%	8.2%
Brazil	-24.4%	-4.4%	8.9%
China	6.9%	-29.8%	9.7%
Japan	21.1%	0.0%	-1.9%
South Korea	16.5%	15.2%	-0.7%
Other markets	0.0%	-13.2%	-6.6%

The end result for pricing for all of this comes down to simple supply vs. demand:

Market Balance	2Q20	1Q20	4Q19
Supply growth	3.3%	2.3%	3.5%
Demand growth	1.3%	0.4%	3.6%

This was compounded in 2Q20 because Chile had a supply growth of 9.7% y/y. Chilean salmon goes to the US market where demand was up 2.8% and Brazil where demand fell 24.4%, other North/South American markets were down 5.7%.

Lower Pricing Quickly Lowers Operating Income in Two Ways

When we look at the farming operation for MOWI, there are many fixed costs associated with raising salmon. The price and cost per fish also vary by fish size. Think of it like an airline flight – much of the labor and fees occur on the ground, take-off, and landing. When those costs are spread over a shorter flight, the cost per mile rises more than for a longer flight. With a salmon, there are fairly equal fixed costs of raising a 3kg fish vs. a 6kg fish too. In fact, the 3kg fish may have higher costs as it likely had parasite issues like lice that had to be dealt with which slowed its eating and growth. Plus, the 6kg fish may have commanded a premium price of more than twice the 3kg fish.

In 2Q20, the volume was up about 6%, but revenue for farming fell by 14% due to lower pricing. In 1Q20, pricing was really only starting to get hurt in Chile, but volume and revenue both fell 20%. The fixed cost aspects showed up in both quarters. Costs rose 10% in 2Q on the 6% volume increase and only fell 10% in 1Q on the 20% volume drop.

Farming	2Q20	change	%	1Q20	change	%
Revenue	€548.4	-€91.5	-14%	€510.6	-€128.9	-20%
Op. Costs	€492.5	€44.6	10%	€409.2	-€46.2	-10%
Op. EBIT	€55.9	-€136.8	-71%	€101.4	-€82.7	-45%
EBIT	€6.4	-€195.8	-97%	-€44.7	-€272.6	-120%

So lower prices create negative leverage on fixed costs is the first problem with falling prices. This is evident with the rate of income decline exceeding the rate of revenue decline as prices fall.

The second pricing issue relates to Biomass. This is similar to a mark-to-market charge and it relates to the inventory of growing salmon. MOWI has assumptions in place on how much the fish will cost over its full life to feed, manage, harvest plus the time it will take and the eventual weight and selling price.

This is a non-cash item. When pricing is rising, the biomass value can increase due to that. When pricing is falling, it can see a significant write-down. That was the case in 1Q and 2Q. The table above shows Operational EBIT and reported EBIT. The primary difference between these two figures are biomass estimate changes, JVs, Gains/Losses on derivatives, and changes in internal – here are the primary changes:

Farming	2Q20	1Q20
Op. EBIT	€55.9	€101.4
Gains/Losses	-€5.3	€11.6
Biomass	-€41.7	-€160.6
JVs	€4.4	€1.5
EBIT	€6.4	-€44.7

As COVID caused a large slump in prices at the end of the 1Q, the write-down was higher, even though pricing over the full 1Q was up. In the 2Q, pricing was lower across the board but the write-down in 1Q already reflected much of the lower pricing impact and the write-down was significant but only one-fourth of the prior quarter.

Positives and Negatives for Pricing Going Forward

- **Prices for salmon fell further in July but appear to have bottomed and are now recovering.** Salmon from Chile to Miami fell about 35% with COVID and has now rallied about 30% off the July lows. The price index for Norway has recovered about 6% in recent weeks.

- **There is more air transport possible to markets that have seen rising demand and lockdowns ease.** That should help meet demand in Asia and the US which was hurt lost sales to foodservice businesses.

- Brazil's 3Q is unlikely to be improving as much as other markets in 3Q. Brazil is about 4% of the salmon market and a destination for Chilean salmon.

- **The other problem with Chile was its inventories expanded last quarter. The estimate is about Chile now has 50,000-60,000 tons in frozen inventories.** That is equal to about 10% of one-quarter's sales worldwide. Chile is not going to take inventories to zero – but it is likely to work them down in 3Q creating a headwind.

- **MOWI noted on the earnings call that it is holding almost no frozen inventories – which should have it in good shape:** "*I'd also like to take opportunity to say that we are carrying limited frozen inventory. If you take out the inventory, which is sold then we're close to zero.*"

- The supply growth for 2020 is expected to be 4%. As we noted earlier, demand has been running 200bp below supply growth. Reopening restaurants and air transports should create a closer balance for the rest of 2020.

- **It is worth noting that without the sizeable growth in supply from Chile – 2020's total supply growth would likely be flat or negative. For the 2H of 2020, Chile's harvests should be lower, which should help balance supply and demand further.**

- **For 2021, Chile has cut new smolts by 12% through July 2020, so that indicates less supply growth going forward. The forecast is for only 1% supply growth in 2021.**

Our conclusion is 3Q will be ugly on pricing too from a y/y basis. However, the market should start to balance out better and pricing should improve through 3Q vs 2Q. Pricing is the key metric to driving margins and cash flow. MOWI should be past the worst of things in our view and 4Q should be better than 3Q and improvements should be pronounced in 2021 on small supply growth for the world salmon market.

Even with Impaired Cash Flow, MOWI's Leverage is Not High and Liquidity is High

We still believe MOWI is carrying low leverage on the balance sheet and has ample liquidity.

- Cash is €104 million with another €550 million available on credit lines

- No debt is due until 2Q22

- Debt is €1.5 billion, net of cash and 4x 2Q20 EBITDA of €140 million – Debt to EBITDA is 2.46x. That's obviously impacted by COVID and the pricing issues. EBITDA should rise simply with pricing returning. Based on pre-COVID figures, Debt to EBITDA is 1.58x.

Even with 2Q20's drop-off, MOWI was still free cash flow positive.

Cash Flow	2Q20	1Q20	2019
Cash from Ops	€108.4	€225.5	€759.0
Cap-Ex	€62.3	€75.1	€292.7
FCF	€46.1	€150.4	€466.3
Work Cap	-€73.5	€75.9	-€103.9

- 2Q20 had a drag from working capital in the quarter too. MOWI is guiding to a full year of working capital drag of €90 million as it uses more feed in the 2H and feed is higher cost. Based on 1H results, essentially the full €90 million drag will show up in 2H20 and heavily in 3Q.

- 2Q20 benefited from having €36 million in taxes pushed into 3Q as part of COVID-relief programs. Total taxes for the year are expected to be €140 million and so far, €62 million have been paid.

- 2Q20 has been on pace for the €265 million in cap-ex guidance. There is about half left and it is not clear if MOWI is counting the new licenses it bought in 3Q as part of that. That is another €29 million. Capital spending may be a slightly larger cash need in 2H20.

- We believe cash flow will recover through 3Q but will need to build through the period. It may come in below €100 million with another large drag from working capital and more taxes. 4Q should look much better in our view due to higher seasonal sales and a longer period with firmer pricing.

The company is also conserving cash by suspending the dividend at this time. The board noted this in 2Q results:

> *"Distributing dividends to its shareholders is an essential part of Mowi's financial strategy. At the same time the Board considers it of utmost importance to maintain a strong financial position, particularly in light of the ongoing Covid-19 pandemic. Hence, under the prevailing circumstances the Board has not found it appropriate to distribute a quarterly dividend for the first and second quarter."*

The dividend is normally €137.5 million per quarter. The decline in pricing in 2Q cost MOWI more than that in operating income. We believe the dividend will return with more normalized pricing. Also, MOWI has the liquidity on hand to cover its cash needs from operations in our view. **The cash needs in 2H20 will be higher than 1H20, but the level of increase is easily covered with cash on hand, improved 4Q results, and/or available credit lines.**

Three Other Positive Issues to Consider

Consumer Products has responded well to the lockdowns as consumers bought more salmon at retail rather than restaurants of late.

Cons Prod	2Q20	2Q19	Eur 20	Eur 19	Am 20	Am 19	Asia 20	Asia 19
Revenues	652.4	648.7	458.4	457.8	114.6	99.3	79.3	91.6
Op EBIT	23.3	7.5	11.0	1.1	11.3	3.8	1.1	2.6
Margin	3.6%	1.2%	2.4%	0.2%	9.9%	3.8%	1.4%	2.8%

The first two columns show the y/y growth for the full unit. Then the three markets served: Europe, the Americas, and Asia complete the table.

- Europe is more established and it also sells to foodservice locations. So, lockdowns hurt sales in that area. Also, the lack of air transport to many markets meant Europe had more supply. Even with lower salmon costs to help margins, the glutted market meant lower retail prices too. So, Europe ended up with some pressure on sales that likely would have dropped straight to income under a more normalized shipping time.
- The Americas benefited from growing demand and lower salmon prices. It actually out-earned Europe with one-quarter of the revenue.
- Asia suffered from lack of transport and not getting enough product.

We think the Americas can become much larger than Europe. MOWI has the infrastructure in place and is getting into retailers. It had a big marketing push planned for 2020 that they delayed due to COVID. That effort should be coming in later 2020 and in 2021 now. We think this region for Consumer Products can become a steady source of revenues and profits.

Cost reduction has been a focus that is getting even more attention. MOWI spends money on new technology to breed healthier fish – that will require less medical attention. MOWI has invested in new pen designs, light treatments to ward off parasites like sea lice, freshwater rearing pens where the fish can avoid parasites, and well-boats that can store fish in water that is continually cleaned and makes harvesting easier. Essentially, healthier fish eat better, put on weight faster, and require less incremental costs for lice removal or vaccines. It has built its own feed operations, which can lower costs and improve pricing as it gives them a longer list of data points on the chain of custody for each salmon. A new area being focused on is reducing labor as a percentage of total costs. Currently labor is 16% of the total and MOWI believes it can adopt more automation to reduce that percentage as it expands the total volumes.

The focus will be to cut 10% of labor cost per unit going forward. Also, continued focus will be on solving more of the biology issues (parasites and fish diseases). MOWI is expecting some tougher cost issues in that area in Scotland for 3Q. However, it has seen 2019 generation fish as being less troublesome overall than 2018 generation.

DESS Aquaculture spinoff is possible. One of the technological advancements has been a JV that MOWI has built over the last 4-years has been a fleet of well-boats. These boats supply fish pens, harvest fish, carry live fish, and produce freshwater from seawater to help combat sea lice on the fish. As salmon farming has increased, rates to contract well-boats has been increasing. There are more boats coming so this JV continues to grow and has a place in boosting technology to lower salmon farming costs. MOWI owns 50% of this venture and is starting to explore ways to monetize this investment.

Microsoft (MSFT) 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 maintain our earnings quality rating at 4- (Acceptable)

- Intelligent Cloud unearned revenue fell slightly despite an increase in revenue. This drove unearned revenue on a days of sales basis down by almost 23 days versus a year ago after 21-day and 16-day declines in the 3/20 and 12/10 quarters, respectively. The company continues to cite a larger portion of revenue growth coming from longer-term commercial deals and hybrid contracts which have a larger percentage of revenue recognized upfront as being a factor. Nevertheless, revenue growth is currently getting a boost from more revenue from these deals being booked upfront and when this trend decelerates, it could take a material source of recent growth with it.

- MSFT noted in its 10-K that it will extend its estimate for the useful life of network equipment in calculating depreciation to 4 years from 3 in FY 2021. This will boost operating income by $2.7 billion which amounts to about 28 cps or roughly 7% of FY 2020 adjusted EPS. This is a material, non-operating benefit to earnings growth that will end after FY 2021 and is especially helpful given that the company has accelerated its capital spending to build out its cloud network. We give kudos to management for its disclosure of the move and its discussion of it in the conference call. We also do not view 4 years as a glaringly long time to expect network equipment to last. However, given the size of the benefit and the fact that depreciation is currently running just over 60% of capex, we do question the need for and the timing of the move.

Decline in Unearned Revenue

Deferred revenue for the Intelligent Cloud segment declined YOY despite an increase in revenue as seen in the following tables:

Revenue by Segment	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Productivity and Business Processes	$11,752	$11,743	$11,826	$11,077
Intelligent Cloud	$13,371	$12,281	$11,869	$10,845
More Personal Computing	$12,910	$10,997	$13,211	$11,133
Total Revenue	$38,033	$35,021	$36,906	$33,055
Unearned Revenue by Segment				
Productivity and Business Processes	$18,643	$14,077	$14,266	$15,560
Intelligent Cloud	$16,620	$12,984	$13,766	$15,255
More Personal Computing	$3,917	$3,336	$3,189	$3,211
Total Unearned Income	$39,180	$30,397	$31,221	$34,026

Revenue by Segment	6/30/2019	3/31/2019	12/31/2018	9/30/2018
Productivity and Business Processes	$11,047	$10,242	$10,100	$9,771
Intelligent Cloud	$11,391	$9,649	$9,378	$8,567
More Personal Computing	$11,279	$10,680	$12,993	$10,746
Total Revenue	$33,717	$30,571	$32,471	$29,084
Unearned Revenue by Segment				
Productivity and Business Processes	$16,831	$12,679	$12,635	$13,753
Intelligent Cloud	$16,988	$12,531	$12,551	$13,298
More Personal Computing	$3,387	$2,925	$2,898	$3,191
Total Unearned Income	$37,206	$28,135	$28,084	$30,242

Intelligent Cloud deferred revenue days of sales fell by almost 23 days YOY in the 6/20 quarter which follows 21-day and 16-day YOY declines in the 3/20 and 12/19 quarters, respectively as seen in the following table:

Unearned Days of Revenue by Segment	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Productivity and Business Processes	144.4	109.1	111.0	129.2
Intelligent Cloud	113.1	96.2	106.7	129.4
More Personal Computing	27.6	27.6	22.2	26.5
Total Unearned Income	93.7	79.0	77.8	94.7

Unearned Days of Revenue by Segment	6/30/2019	3/31/2019	12/31/2018	9/30/2018
Productivity and Business Processes	138.6	111.4	115.1	129.5
Intelligent Cloud	135.7	116.9	123.1	142.8
More Personal Computing	27.3	24.6	20.5	27.3
Total Unearned Income	100.4	82.8	79.6	95.7

As we discussed in our original review, MSFT recognizes revenue under cloud contracts over time while perpetual software licenses are recognized upfront. However, the company has been signing longer-term commercial hybrid contracts as well as usage-based contracts that tend to have more revenue recognized upfront. The company has warned that the mix of hybrid contracts will result in "volatility in commercial unearned" in past discussions of results. Management did not directly address the drop in unearned revenue in the quarter but it did discuss results of the growth sources of the Intelligent Cloud segment:

> *"Next, the Intelligent Cloud segment. Revenue was $13.4 billion, increasing 17 percent and 19 percent in constant currency, slightly ahead of expectations, driven by continued customer* ***demand for our differentiated hybrid offerings.*** *On a significant base, server products and cloud services revenue increased 19 percent and 21 percent in constant currency.* ***Azure revenue grew 47 percent and 50 percent in constant currency, in line with expectations, driven by continued strong growth in our consumption-based business. In our per-user business, growth continued to moderate given the size of our enterprise mobility installed base, which grew 26 percent to over 147 million seats.***
>
> *And our on-premises server business was relatively unchanged and grew 1 percent in constant currency, ahead of expectations, driven by strong renewal execution and the continued demand for our hybrid and premium solutions.*
>
> *Enterprise Services revenue was relatively unchanged and grew 2 percent in constant currency as growth in Premier Support Services offset consulting delays."*

It is reasonable that disproportionate growth in hybrid contracts along with growth in consumption-based Azure contracts could result in more revenue being recognized upfront. The typical concern with a decline in deferred revenue days is the possibility that it could mean either management is becoming more aggressive in recognizing revenue or the pace of signing up new deals is declining. We do not see evidence of either given that booking growth remains strong and it is coming disproportionately from areas that could conceivably have a higher degree of revenue recognized at the beginning of the contract term. In its 10-Ks, the company gives an estimate of the amount of current deferred revenue that will be recognized by quarter throughout the following year. The disclosure from the last two 10-Ks is shown below:

	from 6/20 10-K:		from 6/19 10-K:	
unearned revenue to be recognized in:	est. in FY 2021		est. in FY 2020	
1Q	$13,884	37.3%	$12,353	33.2%
2Q	$10,950	29.4%	$9,807	26.4%
3Q	$7,476	20.1%	$6,887	18.5%
4Q	$3,690	9.9%	$3,629	9.8%
Thereafter	$3,180	8.5%	$4,530	12.2%
	$39,180		$37,206	

We can see from the above that the company has already predicted that it will be recognizing a noticeably higher percentage of the existing unearned revenue balance in the early quarters of FY 2021 compared to its expectations for deferred revenue at the beginning of FY 2020.

Also, the company reports the remaining performance obligation (RPO) related to commercial contracts which includes Intelligent Cloud. This number is essentially backlog and represents the amount of future revenues that the company has signed but has not booked as revenue yet. Some of this would be included in deferred revenue, but some is more than a year out and has not been recognized in the financial statements yet. Note that RPO includes non-Intelligent Cloud components such as Office 365 Commercial, but Intelligent Cloud is a major component.

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Commercial Remaining Performance Obligations	$107,000	$89,000	$90,000	$86,000

	6/30/2019	3/31/2019	12/31/2018	9/30/2018
Commercial Remaining Performance Obligations	$87,000	$72,000	$69,000	$68,000

RPO is still growing in 20%+ rate which is another indicator that there is plenty of backlog left to be recognized as revenue in future quarters. This fact is why we choose, for now, to maintain our rating rather than drop it to a 3 (Minor Concern).

However, even though there may be a reasonable explanation for the unearned revenue decline, the fact remains that revenue growth is likely receiving a material boost from a shift in the type of contract being signed. We have no way to tell when that shift will end, but when it does decelerate, a material tailwind to growth will be gone.

Change in Depreciable Life Will Provide Material Boost to FY 2021

MSFT noted in the 10-K that it will be lengthening its estimate of useful lives for calculating depreciation on its server and network equipment from 3 years to 4 years:

> *"In July 2020, we completed an assessment of the useful lives of our server and network equipment and determined **we should increase the estimated useful life of server equipment from three years to four years and increase the estimated useful life of network equipment from two years to four years**. This change in accounting estimate will be effective beginning fiscal year 2021. Based on the carrying amount of server and network equipment included in "Property and equipment, net" as of June 30, 2020, it is estimated this change will increase our fiscal year 2021 operating income by $2.7 billion."*

The $2.7 billion benefit amounts to just under 30 cps or about 7% of the FY'20 adjusted EPS figure. In addition to the above note in the 10-K, the company also prominently made note of it in the conference call.

We do not have a problem with using 4 years to depreciate server equipment and network equipment. However, MSFT has been at this a long time and we question the timing of the change, particularly the doubling of the useful lives for network equipment. We note that the change produces a huge benefit, particularly as the company continues to invest in equipment as it builds out its cloud infrastructure. The following table shows depreciation expense as a percentage of capital spending for the last three fiscal years:

	FY 2020	FY 2019	FY 2018
Capital Spending	$15,441	$13,925	$11,632
Depreciation Expense	$10,700	$9,700	$7,700
	69.3%	69.7%	66.2%

Capital spending growth is elevated, but depreciation expense comfortably trails it and the gap actually increased in FY 2020. Taking $2.7 billion out of the FY 2020 number would have dropped FY 2020 depreciation expense to under 70% of the capital spending figure from FY 2018. Therefore, we question the need for the change. Either way, this will be a significant tailwind to EPS growth that analysts should remember will only last through FY 2021.

Lamar Advertising (LAMR) 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)

LAMR reported AFFO of $0.95 in the 6/20 quarter which was 7 cps below consensus targets. We saw some minor red flags in the quarter but not enough to lower our rating yet.

- LAMR's AFFO (adjusted funds from operations) includes and add back of maintenance capital spending. We noted that the company's annual maintenance capex run rate at the time of about $45 million figure looked small when considering that real estate depreciation and amortization expense was well over $200 million. This concern was amplified by the fact that an increasing percentage of billboards are digital (some picked up in acquisitions) and will be expensive to replace. The company's total capex spend fell to $10.6 million in the 6/20 quarter from $25 million in the previous quarter. However, maintenance capex declined to $3.8 million versus $10.6 million in the previous quarter. For perspective, a $1 million decline in maintenance capex adds about a penny per share to AFFO. The company is forecasting maintenance capex expense of $10 million for the second half of the year which compares to $26 million in the second half of 2019. We believe maintenance spending will have to rebound rapidly to avoid problems with displays down the road which will be a drag on reported AFFO growth.

- We note that in 2019, the company was required to capitalize contract fulfillment costs after the mandatory adoption of ASC 606 for revenue recognition. These amounts include costs such as setting up new advertising displays. The company disclosed amounts capitalized and the associated amortization costs. In the 12/19 quarter, the company capitalized $5.6 million in fulfillment costs and recorded amortization expense for $6.4 million. However, this disclosure disappeared in the 3/20 10-Q which the company attributed to the fact that it was no longer material. COVID resulted in a sharp decline in fulfillment costs as few new contracts were being signed. Regardless, we hope to see this disclosure return when conditions normalize as the amounts in question are typically material and should be monitored for signs in changes in the rates of capitalization and amortization.

- Management stated in the conference call that it will recommend that the Board maintain the cash dividend at 50 cps in the third quarter, consistent with the second quarter and half the dividend from the first quarter. This represents an AFFO payout of 53%. The company has cut total capex spending for the second half by more than $67 million versus a year ago and it now expects $60 million in cost savings for the year, up from its original forecast of $50 million. After its recent redemption of $535 million of senior unsecured notes, the company has liquidity of approximately $10 million in cash, $50 million remaining on its receivables securitization facility, and $640 million on its revolver. Management touted in the call that June was very strong for signing up new deals although it saw some leveling off in July as COVID cases spiked. The company should be in a good position as conditions normalize as it is largely located in smaller markets which avoid delays in national advertising campaigns and also are signed over shorter time frames which make for less of a commitment for customers. All of this makes us believe the current dividend is safe for now and will likely be raised quickly as the market returns to normal.

Mohawk Industries (MHK) 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 of 3+ (Minor Concern)

Our last note on MHK focused on new allegations made in the company's shareholder lawsuit and related government investigation. The complaints allege that the company engaged in a long-running, elaborate scheme to post fictitious sales by essentially faking deliveries of products on the last weekend of the quarter as well as concealing warehouses full of faulty inventory that should have been written off. We concluded that there was some evidence of minor channel stuffing early in the period but we did not see anything in recent results indicating the type of wide-scale fraud alleged in the complaint. Following the 6/20 quarter results, we note the following:

- The company did change the wording of its disclose regarding the lawsuit. In previous SEC filings, the company stated that it "believes the claims are frivolous and intends to defend them vigorously" to "the Company intends to vigorously defend against the claims." This is likely just lawyers softening language and we would not read too much into it.

- On the subject of inventories, quarterly DSIs fell by 12 days versus last year's second quarter. The company noted that its markets recovered faster than it anticipated and its production efforts were dampened by local restrictions and employee absenteeism which accounted for the decline in inventories. This claim indicates that inventories are working themselves down without a write-off which continues to make us skeptical that the company hid massive amounts of faulty inventory for years.

Quick 2Q Notes on Other Companies

Altria (MO) – Maintain SELL. Company did not take a write-down in 2Q20 despite pointing out again that the fair value of its investment in Anheuser Busch is "now well below the carrying value of its investment in ABI." Also, ABI cut its dividend again – so there is less cash flow coming in from the investment to MO. However, ABI did determine the value of its African assets was too high and took a $2.5 billion impairment charge in 2Q. That was one of the key growth reasons to buy SABMiller in the first place.

MO also did not take a write-down its Cronos investment in 2Q20 after pointing out the fair value is below its carrying value. However, Cronos did take a $3.1 million inventory write-off against revenue of only $7.7 million citing price compression in its market. It also lost $22 million on $7.7 million in sales.

Ocean Yield (OYIEF) – Maintain NEUTRAL. We do note that the company's reduced dividend is currently yielding 8% and looks sustainable. More importantly, three more of its oil-service related vessels have been dealt with. It sold the 75% interest in the SBM installer and will receive $30 million to enhance liquidity.

The Far Senator and Far Statesman have been earning zero for nearly two years under a standstill agreement with Solstad as it restructured debt with creditors. There is now an agreement that should be finalized in 3Q. Under the terms of the deal, Ocean Yield's two ships will be part of a pool of seven similar vessels in total. They will earn a fee based on the average charter rate of the pool vessels. Several of these vessels are working currently, with the Statesman recently signing a new charter. OYIEF should start to collect revenues again from these vessels in 3Q or 4Q. It will also receive stock in payment for the past revenue that it deferred.

It entered a JV with its parent Aker on 4 product tankers and 3 oil tankers that infused $10 million in capital to Ocean Yield. It netted another $11 million after retiring debt from an insurance claim on a car carrier vessel in 3Q. The wildcard remains the FPSO, which is being evaluated for three different projects. It recorded costs of $2.8 million the quarter, which Ocean Yield expects to reduce. FCF is running about $55-$60 million per quarter giving cushion to sustain the quarterly dividend of under $9 million in our view plus pay down debt as the company awaits the FPSO outcome. The other wildcard is the Connector – which continues to operate on a series of lumpy short-term contracts. There is demand for it, but Ocean Yield continues to avoid a long-term deal at a low fee, vs waiting for the market to improve further. So, an 8% yield, but likely the FPSO needs to be resolved before there is reason to believe in a catalyst for some growth.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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