BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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AT&T (T) 3Q'20 Update
Maintain BUY

We are maintaining our BUY recommendation on T. Adjusted EPS of $0.76 met estimates. It declined from adjusted EPS of $0.94 y/y. The items AT&T adds back looks largely tame. We think a case can be made that between COVID impacts and HBO Max rollout costs – underlying apples-to-apples EPS actually grew about 10-cents in 3Q y/y.

3Q results show many of the same impacts as 2Q. COVID hurt wireless with a loss of international roaming fees from less travel along with T not charging late fees or data overage fees. Where it hurt the most was movies for WarnerMedia not being released.

EPS Adjustments	3Q20	3Q19
GAAP EPS	$0.39	$0.50
Amortiz of Intang.	$0.22	$0.19
Debt Refinancing	$0.14	$0.00
Actuarial Loss	$0.01	$0.21
Merger/Integration	$0.00	$0.04
Adjusted EPS	$0.76	$0.94

- We have issues with companies adding back the amortization of acquired intangibles. The deal consumed cash upfront and the expense lasts for a long time. Had they built it in-house, all the labor and research would have been expensed and not added back. When looking at dividend payout ratios – we are fine adding it back.

- The debt refinancing is a one-time item and it should benefit future results. AT&T refinanced debt and had to pay $1.2 billion in premiums and $0.2 billion in other fees. Interest expense fell by 20bp – which will add 1-cent to quarterly EPS going forward. Also, it reduced debt maturities through 2025 from $66 billion to $33.5 billion. This is a one-time item, we do not have a problem adding back.

- In 2019, AT&T was cutting costs by offering incentives and early retirement to many employees. The level of payments from the pension plan exceeded the normal size and resulted in settlement accounting treatment. This required pension obligations to be revalued each quarter and it also required actuarial losses to be recognized in income. This is a one-time item and recognizing losses is a non-cash event. For comparability, we do not have a problem adding this back.

- Merger costs in 2019 accounted for 4-cents. We believe mergers cost money and require work and other expenses and do not like to see serial acquirers add back these costs if they recur annually. For comparability at AT&T, it does not happen every year, so we understand adding it back.

- In our view, on comparability AT&T could adjust for a couple other items as one-time items too. For example, it is spending $2 billion this year to roll out HBO Max, which was $600 million in 3Q. That is 7-cents of expense in 2020 that didn't happen in 2019 – (we would add- that was modelled into the estimate of $0.76 so it should not be added back to look at whether AT&T beat forecasts). Also, COVID is listed as a $0.21 item for the quarter – the bulk of which hit WarnerMedia revenues. It also wiped out International Roaming fees, late charges, and data overage charges at wireless. That was listed as $430 million in EBITDA or $0.05. Only $0.02 was higher costs for COVID related precautions and overtime.

- We are fine not adding back COVID expenses and that is more conservative. Given that much of it was revenue that should in fact occur – just at a later date regarding movies while some of the sports are gone forever.

So, EPS was down 18-cents. We think HBO Max represents 7-cents of that drop, and if COVID is 21-cents – then EPS from an apples-to-apples comparison is doing better by 10-cents y/y. There are some aspects we can quantify:

- 1-cent came from share repurchases.
- 1.2 cents came from lower interest expense.
- 2-cents came from lower churn rates for postpaid wireless.
- 3-cents from the 4Q'19 cost-cutting program.

Going forward, we expect more y/y declines in interest expense after refinancing and retiring more debt. The 20bp reduction in place adds 1-cent per quarter. Also, with the debt rate at 4.3%, the pretax cost of capital for the dividend is 8.5%-9.0% where the stock is trading. We would expect to see more share repurchases in the future. The fact that debt maturities are smaller now and Free Cash Flow after the dividend is expected to be about $11 billion this year plus $3 billion in asset sales – should make it possible to buy more shares.

The churn rate is falling with a combination of bundling HBO Max, adding First Responders to the system, 5G roll-out, and new phones. The churn rate dropped from 95bp to 69bp y/y. The company has stated that every bp decline is worth $100 million per year at wireless. Looking at EBITDA margins, that should net to about $6 million in earnings per quarter. That area has shown sizeable improvement. The number of subscribers and connections rose 8.9% so this division is still growing. Margin was actually pinched a bit due to higher amortization of deferred commissions – that may not continue as a headwind. Getting the roaming fees, late charges, and overage fees back should also enhance margins as well as revenue.

AT&T started a cost savings program in 4Q19 that was expected to save $1.5 billion by the end of 2020. They said half of that was already in place early in 1Q. The full amount of this would be 4-cents per quarter, maybe 3-cents is already being seen. There is another plan that began at the same time to save $2 billion by 2022. This plan may not have had much impact yet.

Welltower (HCN)
Cancel SELL
Initiation of EQ Coverage

Current EQ Rating*	Previous EQ Rating
3-	na

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 canceling our SELL recommendation on WELL as the new structure has already shown many of the risks we had highlighted. Essentially this is a very high fixed-cost business that needs very high occupancy to make money, but residents churn over a 30-36 month cycle requiring it to bring in significant numbers of new residents all the time. COVID halted new move-ins and accelerated move-outs. Its moves to become an operator inflated the REIT stats by omitting several ongoing costs and still viewing the company as a triple-net lease landlord. And now the CEO has left. Liquidity was enhanced by issuing new debt and selling properties and should be adequate with small near-term maturities.

We are initiating earnings quality coverage of WELL with a rating of 3- (Minor Concern)

What concerns us most is the WELL has changed its operating model considerably over time, but still does not update its key reports stats to reflect it has higher cash outflows under the new operating model. Funds from Operations are overstated in our view. There remain several areas of risk for further impairments in our opinion too.

What Is Getting Worse:

- As an operator of senior housing more than a passive triple-net landlord these days, WELL should adjust its FFO calculation to account for capital spending on existing properties. This lowers pre-COVID FFO/share from $3.70-$3.90 to about $3.00.

- Falling occupancies should pressure FFO for a longer time as operating leverage unwinds too. This can cause more impairments.

- WELL adds back losses from non-consolidated entities in its FFO calculation. However, it consistently is a net drag on cash flow of about $50 million, or another 12-cents in FFO.

- Write-offs and impairments continue to hit the property book as WELL restructures additional properties from triple-net to JV's where it shares the costs and profits of operating the facilities.

What Is Getting Better:

- The 30% dividend cut improves the coverage considerably.

- The company boosted liquidity by issuing debt, selling properties, and paying down near-term maturities. It should be able to ride-out COVID. Its net debt figure is still 5.7x EBITDA.

- WELL's real estate lending book may have been through the worst of its Genesis story. It has collected, written off, or reserved for 55% of the loan at this point.

What to Keep Watching:

- WELL has become more focused on buying/building properties and selling them too. Gains from selling facilities are half of pre-COVID income.

- This creates a circular issue – if sold property is not replaced, then future FFO declines. If it is replaced – WELL has a history of seeing purchases exceed sales in dollar terms and it funds that shortfall by issuing more stock.
- The share count is up 20% since 2015 and ROI generally ranges between only 7.5%-8.5% using EBITDA less maintenance spending – which gives them credit for the gains achieved on property sales.

- Non-consolidated entities historically carried more debt and consistently lose money – WELL may have to invest more in this area on existing deals.

Senior Housing Has More Expenses than Triple-Net Leasing – WELL Does not Adjust for This in Stats

Originally, Welltower was overwhelmingly a straight landlord under triple-net lease arrangements. That means it owned the real estate and another company operated the business and paid rent to WELL. It also means that the operating company covered taxes, maintenance/upkeep, capital upgrades, and insurance. This effectively makes the rent payment smaller.

Over the last 5 years, Welltower moved away from the triple-net structure and into being the owner/operator of properties. This is the Senior Housing unit. On the surface, WELL can collect more money on the top-line than with triple-net leases. However, it also has more operating expenses to pay such as running the business, property taxes, insurance, and capital spending to repair and upgrade the property. In its reported REIT stats, Welltower does not adjust for this change in business model – it simply touts that it has become more profitable via Funds from Operations – which is Net Income + Depreciation/Amortization + Impairments +/- Gains/Losses – non-consolidated entity income:

	2019	2018	2017	2016	2015	2014	2013
Reported FFO	$3.91	$3.71	$3.16	$4.39	$4.03	$3.82	$3.32
CapX existing units	$0.81	$0.71	$0.68	$0.61	$0.54	$0.43	$0.49
Adjusted FFO	$3.10	$3.00	$2.48	$3.78	$3.49	$3.39	$2.83
Dividends/Share	$3.48	$3.48	$3.48	$3.44	$3.30	$3.18	$3.06

We think this is important because on the FFO figures WELL reports, it has enjoyed solid dividend coverage for a REIT. But, subtracting out the recurring capital spending for properties where the company is the operator and a third-party tenant is paying the maintenance and capital improvement – suddenly WELL has not covered its dividend since 2016.

COVID made this worse and it gave the company an excuse to cut the dividend from 87-cents/quarter to 61-cents. The cuts may not be finished:

	2Q20	2Q19	1Q20	1Q19
Reported FFO	$0.80	$0.96	$0.86	$1.17
CapX existing units	$0.10	$0.17	$0.17	$0.14
Adjusted FFO	$0.70	$0.79	$0.69	$1.03
Dividends/Share	$0.61	$0.87	$0.87	$0.87

- WELL is claiming – "normalized" 2Q'20 FFO is 86-cents based on COVID-related expenses

Here are the items we think investors should focus on:

- With COVID, WELL slashed its maintenance Cap-Ex in 2Q20. That will need to rise going forward in our opinion. That could squeeze real FFO more going forward.

- The change to owning and operating the properties has not led to income growth. FFO adds back impairments and gains/losses. FFO/share has been falling since 2016.

- FFO also adds back the impacts the unconsolidated entities and noncontrolling interests – we will discuss these below – but they have been consuming cash also.

- WELL has shed more operating income from Triple-Net than it gained from Senior Housing. Operating income in Triple-Net fell from $1.2 billion in 2015 to $450 million in 2019. Seniors Housing rose from $700 million to just over $1 billion for the same period.

- The operating results are likely to get worse before they get better and lower FFO more due to falling occupancy rates. At the same time, most costs to run the facilities are largely fixed.

- The Net Debt to EBITDA is 5.7x ($12.76b / $2.25b). The highest EBITDA has ever been is $2.33 billion. That level of debt may pressure the dividend even though near-term maturities are not heavy.

- Earnings are lower than FFO too - $3.05 in 2019 EPS vs. $3.91 in FFO and 2Q20 EPS was 38-cents vs. 80-cents in FFO. We think there could be more impairments to push down EPS and the dividend requirements of 90% payout are driven by EPS not FFO.

More Impairments Seem Likely in Several Areas Due to Low Occupancy

In looking at WELL, it invests in Senior Housing in a number of ways. In nearly every case, the operating economics include heavy fixed costs and profits require a high occupancy rate. It really gets down to the fact that the whole facility has to be cleaned and maintained whether 8 people live there or 80. The same is true with cooking meals and having medically trained staff on-site. Utilities, insurance, and vehicles all add costs.

Senior Housing has been an area in real estate that has been overbuilt. People have waited longer to move-in. Because they wait longer, they may have more health issues and require more care which also adds more to costs. On the 2Q'20 conference call, the CFO confirmed this again, saying, "move-in pick-ups are really going to your most needs-based resident."

Plus, the older properties have to compete even more on price and can pressure the prices others can charge. We have discussed in the past how several times players in this industry have said the only way they can get a meaningful price hike is to get it from new residents as the current residents simply are not there long enough for 1%-2% annual price increases to make a difference. On top of that, residents turn over quickly. The typical resident lives in Senior Housing about 30-36 months. So, all these properties need to add new residents that replace one-third of their current occupants every year just to post flat results.

From what we have seen, break-even for a senior living property is occupancy in the high 70%-low 80% range. Companies in the past with occupancies of about 85% have seen profits falling as their cost inflation cannot be absorbed at 85% occupancy. Also, there have been acquisitions done with figures below that occupancy where the buyer essentially said, "we are confident we can turn it around and we are buying the real estate below replacement cost."

The first problem we see is occupancies were not very high coming into COVID and they have dropped off since then. The decline has been in place since 2016:

Occupancies	2Q20	1Q20	2019	2018	2017	2016	2015
WELL Sr Housing	82.9%	86.9%	86.9%	87.5%	85.8%	86.5%	87.2%
WELL Triple Net	85.6%	86.1%	84.3%	84.9%	86.5%	88.7%	91.0%
Brookdale	77.8%	83.0%	83.9%	84.3%	85.0%	86.0%	86.9%
Healthpeak	79.8%	85.7%	83.0%	85.0%	87.0%	88.0%	87.0%
Ventas	82.2%	86.6%	86.6%	87.0%	88.3%	90.3%	91.2%

Take some of this with a grain of salt as companies like WELL actively traded properties and moved more into JVs during this time and to other non-consolidated entities where they own under 50% and may be out of the metrics. (In fact – they just completed another sale of senior housing into a JV they own). They would have kept some of the better-performing ones and focused on culling weaker performers. But the long term trend has fallen off. Also, these are often the one month snapshot for occupancy rates. WELL provided another snapshot of recent month-by-month occupancies for senior housing:

Occupancies	20-Jul	20-Jun	20-May	20-Apr	20-Mar	20-Feb
WELL Sr Housing	79.4%	80.1%	81.0%	82.8%	85.0%	85.8%

Falling occupancy and COVID have multiple negative implications for cash flows to test for impairments as well as simply the cash flows that make up FFO:

- COVID means higher mortality rates of current residents – so they need a higher replacement rate
- COVID means people are more afraid to move in and there may be higher health quality requirements to move in.
- COVID boosts training, cleaning, new repairs/upgrades to facilities, and perhaps other medical operating costs
- Falling occupancies have normally led to lower rents for new residents
- Falling occupancies simply reduce operating leverage – and thus lower cash flow and operating income and several of these players are at the problem stage now
- High debt levels mean the equity values for these investments will suffer the most if income levels drop

Welltower Has a Sizeable History with Impairments and Restructuring

The bullish case for WELL used to center on master-lease arrangements with Triple-Net operators. The Aging of America story would boost demand, allow the operators to raise prices and occupancy, and if there were problems with any facilities – the operator couldn't just toss it out of the portfolio due to the master-lease. Despite all this – WELL managed to see many types of problems:

	2Q20	1Q20	2019	2018	2017	2016	2015
Impairments	$77.0	$60.1	$28.1	$115.6	$124.5	$37.2	$2.2
Loan Losses	$1.4	$7.1	$18.7	$0.0	$63.0	$10.2	$0.0
Other Exp.	$19.4	$6.3	$52.6	$112.9	$177.8	$12.0	$46.2

- 2Q20 – Entered a contract to sell six Senior Housing properties and the price triggered a $56.4 million impairment. Another sale of property caused an $18.8 million impairment.

- 1Q20 – Wrote off $32.3 million in rent as it amended a lease. It also wrote off $27.8 million to reflect properties carried at a level above Fair Market Value.

- 2019 – Wrote off $18.7 million in real estate loans receivable deemed uncollectible.

- 2018 – $81.1 million to terminate a Triple-Net relationship and restructure it as Senior Housing in a JV – appeared in other expenses.

- 2018 - $79.6 million to terminate another Triple-Net relationship and restructure the deal as Senior Housing.

- 2017 - $88.3 million in other expenses to terminate a Triple-Net relationship and restructure deal.

- 2017 - $96.9 million impairment taken against 21 properties.

- 2017 - $63.0 million of first mortgage notes of Genesis written off.

- 2016 – like 2017, found value impaired for 22 properties and wrote off $20.2 million plus a $6.9 million of Genesis first mortgage notes written off.

- 2015 - $35.6 million charge in other expenses as Genesis value above Fair Market Value.

Some things to keep in mind: 1-cent in FFO is currently about $4.2 million and they are adding back impairments in calculating FFO. Adjusted for the maintenance spending, we see pre-COVID FFO at about $3.00 per share. WELL is routinely getting about 20-cents of $3.00 by adding back all these recurring "one-time" items. They are not adjusting for the charges taken in "other expenses" so in 2017 for example – it added back the $96.9 million impairment of properties but not the $88.3 million to terminate and restructure a Triple-Net lease in other expenses.

Further, Triple-Net lease operators have no incentive to convert a solid operating property to a Senior Housing structure and split the profits/losses with WELL. In the case say of an occupancy of 90%-95%, that operator loves having a low fixed lease payment to WELL and keeping all the profits for themselves. If they are losing money, having WELL sign on to cut rent expense, fund some of the losses and capital improvements in return for potentially higher profits if occupancy rises sounds like a reasonable deal to pursue. **The key is these are more troubled properties in the first place and WELL is assuming more risk making these conversions and recognizing impairments in the process.**

As WELL has pulled more troubled properties out of Triple-Net and moved them to Senior Housing where they share in operating expenses, profits and losses – the growth in Triple-Net same-store operating income has improved while same-store operating income in Senior Housing has declined:

SS NOI Growth	1H20	2019	2018	2017	2016
Sr. Housing	-16.1%	-0.2%	-1.0%	1.4%	1.2%
Triple-Net	1.7%	1.5%	1.5%	1.6%	-5.2%

Two of the bigger companies where WELL has become more involved via joint ventures and converting troubled Triple-Net leases into Senior Housing partnerships are Sunrise and Revera. These are 23% and 11% of Senior Housing operating income. WELL owns 34% of Sunrise. They appear to be doing even worse than the same-store portfolio has a whole:

SS NOI Growth	2Q20	2Q19	2Q18	2Q17
Sunrise	-39.4%	-4.1%	6.5%	10.0%
Sunrise units	127	123	124	116
Revera	-32.4%	-6.5%	1.3%	0.0%
Revera units	94	98	98	98
Full Sr. Housing	-24.7%	-1.7%	0.0%	-2.6%

- If we adjust for the growth of Sunrise units helping drive higher NOI – we estimate the **10.0% in 2Q17 growth becomes -1.3% dividing** NOI by 116 units compared to NOI divided by 104 units in 2Q16. **The 6.5% growth in 2Q18 become 0%** under the same adjustment.

Unconsolidated Entities Pose Risks Too

A great deal of WELL's Senior Housing is operated in JVs where the company owns more than 50% of the deal and/or is considered the Primary Beneficiary. There are also investments that are not consolidated. This is where ownership is 10%-50% and WELL is not the Primary Beneficiary. 72% of these entities represent Senior Housing as well. We see several points of concern with these entities:

- WELL does not make money with these deals. It is carrying these assets on the books for $786.9 million. Nearly every year, the cash outflow to unconsolidated entities exceeds the cashflow in from those entities:

N/C Entities	2Q20	1Q20	2019	2018	2017	2016	2015
Income from N/C	$1.3	-$3.7	$42.4	-$0.6	-$83.1	-$10.4	-$21.5
Cash to N/C	-$88.6	-$137.1	-$279.6	-$136.9	-$114.4	-$101.4	-$160.3
Cash from N/C	$5.2	$3.6	$216.2	$90.9	$70.3	$119.7	$130.9
Impact on FCF	-$83.4	-$133.5	-$63.4	-$46.0	-$44.1	$18.3	-$29.4

- The $42.4 million in income for 2019 includes a one-time gain of $38.7 million

- WELL still expects to fund another $212.3 million to these entities as of 6/20.

- The income (loss) from non-consolidated entities is adjusted out of FFO because it is non-cash. However, these investments are routinely a net cash drain. **As we showed above, FFO after paying for Capital Spending at existing properties is about $3.00 per share pre-COVID. A $50 million cash flow drain is 12-cents per share that WELL has to cover before the dividend.**

- WELL stopped disclosing the balance sheet information for these investments in 2017. We know total liabilities to equity was 2.7x and 2.75x in 2017 and 2016. For June 2020 and December 2019 – WELL's balance sheet was just under 1.0x total liabilities to equity. Assuming the non-consolidated entities still have similar balance sheets – there is much more leverage at work here for entities that as a whole are losing money.

- WELL could face the risk have having to invest larger sums into these investments if other partners bow-out if more cash is needed. It has already boosted its exposure. Its share of investments in this area were under $500 million 2016-18 ($483 million in 2018). It is now $787 million.

- WELL may invest more in these deals than they are worth. Their accounting treatment if their investment exceeds Fair Value – the excess will be amortized against WELL's share of income from these entities. We did not find enough information or discussion to determine if this has occurred or if it is material.

Real Estate Loans and Allowances May See Less Fireworks

Welltower ran into one huge loan that became a disaster for it related to Genesis Healthcare. In 2015, WELL had $820 million of real estate loans. In 2016, it had to restructure the $317 million Genesis loan into four different ones. At that time, it took a $6.9 million reserve. Prior to that, its loan loss allowance was zero. These were mortgage loans.

Loan Book	2Q20	1Q20	2019	2018	2017	2016	2015
R/E Loans	$228.7	$223.7	$312.8	$398.7	$495.9	$622.6	$819.5
Loss reserve	$3.9	$2.5	$42.4	$68.4	$68.4	$6.6	$0.0
Allowance %	1.7%	1.1%	13.5%	17.1%	13.8%	1.1%	0.0%
Non R/E Loans	$452.0	$451.3	$362.9	$282.4	$0.0	$0.0	$0.0
Loss reserve	$78.1	$78.1	$26.0	$0.0	$0.0	$0.0	$0.0
Allowance %	17.3%	17.3%	7.2%	0.0%	0.0%	0.0%	0.0%
Total Loans	$680.7	$675.0	$675.7	$681.1	$495.9	$622.6	$819.5
Bad Debt Exp.	$0.0	$6.9	$18.7	$0.0	$63.0	$6.9	$0.0

- In 2017, Genesis deteriorated further and the allowance rose by $63.0 million.

- In 2018, it collected $85.3 million on the loan.

- In 2019, an extra reserve of $18.7 million was taken and written off. It moved one of the four loans to non R/E Loans as the collateral was sold.

- In 1Q20, another Genesis loan was moved to non R/E Loans of $86.4 million along with $42.4 million of loss reserve

Overall the loan book is getting smaller. We would argue that the remaining non R/E Loan book could be viewed as more questionable as it lacks a mortgage. That area is not all the Genesis stuff. Genesis moved it from $282 to $452 million.

Is Welltower Becoming More of a Deal Maker than an Operator?

Two other things jumped out at us in recent years: First, the bulk of income is coming from gains on real estate sales. Second, the share count has grown rapidly.

The company is repeatedly selling assets into its own JVs and booking gains. Other times it is booking gains selling the JVs to other parties. Some of these properties are being purchased and others constructed. We can argue that they have taken impairments and charges against some of these properties before booking the gain. **However, in dealing with the FFO figure – WELL ignores impairments and it ignores the gains. So, there is no impact on FFO.** However, the cash outflow to make purchases continually exceeds the cash inflow from the actual sales. They are in turn funding part of that shortfall by issuing more shares of stock:

R/E Trading	2Q20	1Q20	2019	2018	2017	2016	2015
Cost of R/E Sold	$1,021.0	$528.4	$1,900.9	$1,125.1	$1,011.2	$1,852.4	$543.6
Gain realized	$155.9	$262.8	$748.0	$415.6	$344.3	$364.0	$280.4
Net Proceeds from R/E	$1,196.7	$801.4	$2,650.7	$1,541.9	$1,378.0	$2,350.1	$824.0
Net Income	$159.2	$329.4	$1,330.4	$829.8	$540.6	$1,082.1	$888.5
Gain % of Income	98%	80%	56%	50%	64%	34%	32%
Cash Received on Sale	$1,196.7	$801.4	$2,650.7	$1,541.9	$1,378.0	$2,350.1	$824.0
Cash Spent on R/E	$0.0	-$390.8	-$3,959.7	-$3,560.4	-$805.3	-$2,145.4	-$3,364.9
Construction	-$73.3	-$48.8	-$323.5	-$160.7	-$232.7	-$403.1	-$244.6
Net Cash Change	$1,123.4	$361.8	-$1,632.5	-$2,179.2	$340.0	-$198.4	-$2,785.5
Cash from Eq. Sale	$4.3	$591.0	$1,056.1	$789.6	$622.0	$534.2	$1,755.7
Diluted Shares O/S	419.1	412.1	403.8	375.3	369.0	360.2	349.2

We are looking at this more from a cash flow situation. The only time this isn't a large cash drain is in years when WELL doesn't buy much Real Estate like in 2017 and 2020. The problem then becomes, it is selling off future income in the form of rental revenue and not replacing it. That would reduce FFO and the cash to pay the dividend and the capital spending to maintain the current Senior Housing.

However, if they replace what they sell, then they spend the cash proceeds and then some. The share count is up 20% over this time. Even through the dividend when flat for several years before the recent cut, the total outlay was still increasing. Dividend outlay rose 16% from 2015-2019. Also, their cost of equity capital at $55 per share was 6.3% before the dividend cut. Now it's 4.4%. It's not as though their ROI is that great overall. If we use straight EBITDA – less maintenance spending as a proxy for income, it will give WELL credit for all the gains they have achieved on asset sales, which exceed the impairments. It will also recognize that there is an operating business here that earns rental income and will deduct the non-consolidated losses:

ROI	12 mths 6/20	2019	2018	2017	2016	2015
EBITDA	$2,996	$2,916	$2,315	$1,967	$2,486	$2,213
Maint. Cap EX	$327	$329	$266	$250	$219	$188
Cash flow Proxy	$2,669	$2,587	$2,049	$1,717	$2,266	$2,026
Equity	$16,048	$15,540	$14,632	$14,423	$14,806	$14,591
Debt	$14,436	$14,915	$13,227	$11,732	$12,358	$12,877
less Cash	$1,679	$285	$215	$244	$419	$361
Capital	$28,805	$30,170	$27,644	$25,911	$26,745	$27,107
ROI	9.3%	8.6%	7.4%	6.6%	8.5%	7.5%

We think under the best light – giving WELL full credit for the gains on asset sales – this is a 7.5%-8.5% ROI business. And the difference is often the size of the gain they take as that is such a large part of income. In 2017, the gain was only $344 million and ROI was 6.6%. In 2019, the gain was $748 million, and ROI was 8.6%. 130 bp of the improvement was due to the $404 million larger gain.

For the trailing 12 months ended 6/30, WELL was helped by selling assets and not replacing them. That grew the cash balance and cut the capital figure by $1.4 billion – that added 50bp. The gain for the trailing 12 months was also $1.0 billion. Every $100 million of that added 35bp to ROI. The problem going forward as we noted above – if they sell assets and don't replace them it should make future operating income lower and future gains lower too. That would push ROI down.

Texas Instruments (TXN) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
5+	5+

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 rating of TXN at 5+ following the company's beat by 16-cents.

Within that, the company was helped by amortization of intangibles becoming a smaller figure as they near full amortization. The drop from $79 million to $51 million was a 2-cent EPS tailwind. We still believe amortization should decline further y/y going forward as the asset value is only $189 million. TXN also had an 8-cent headwind from the effective tax rate increasing due to discrete items helping in 3Q19 and 2Q20. However, the 15% rate was only 1% above guidance as a 1-cent headwind.

More importantly, the inventory build in 2Q20 when TXN wanted to be ready to deal with a recovery of demand, showed it is returning to normal levels:

Inventory	3Q	2Q	1Q
2020 Inventory	$2,072	$2,136	$2,003
2020 DSI	139	168	147
2019 DSI	142	145	144
y/y Sales chg.	1%	-12%	-7%

As we have noted before, TXN has the liquidity and ability to carry more inventory. It sees this as a way to drive sales by avoiding out-of-stock situations and obsolescence as low-risk. It also allows them to chase larger customers as it can ensure supply plus it can operate at higher utilization rates. A recovery in sales quickly corrected the issue for us. However, we still believe computer screens will red-flag inventory levels.

It continued to invest in R&D and we saw little else of concern. Guidance calls for revenue growth of 2%-10% in 4Q and EPS growth of 7%-25%. It has about 4% already baked in from share repurchases.

Procter & Gamble (PG) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4+	3+

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

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

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

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

PG reported strong organic growth across all segments and a solid earnings beat of 21 cps. Most notably, the quarter contained no non-GAAP adjustments and minimal restructuring charges for the first time in recent memory, prompting us to raise our earnings quality rating.

Items that Deteriorated

- Accounts payable days of sales rose YOY by almost 5 days continuing the ongoing trend as the company admitted to extending payment terms on suppliers. However, payable days fell sequentially and the growth appears to be peaking. Stretching payables has been a key part of cash flow growth and the lower sequential decline in payables accounted for about $170 million of the $570 million growth in operating cash flow in the quarter.
  (Concern level: MEDIUM)

- Depreciation and amortization declined YOY adding about 1.6 cps to earnings growth. We assume this is likely due to assets becoming fully depreciated but remaining in service. We assign this a low level of concern as the benefit paled in comparison to the quarterly beat, but note that the tailwind could reverse in upcoming quarters as capital spending rises again.
  (Concern level: LOW)

Items that Improved

- PG did not post any non-GAAP adjustments for incremental restructuring charges for the first time in recent memories. The ongoing nature and size of these charges has eroded the quality of non-GAAP earnings, in our opinion. The 2017 program is complete on schedule, but the skeptical side of us is expecting another large program to be announced in the next couple of quarters.

Payable Days Remain Elevated but Have Stabilized

(Concern Level- Medium)

Like many consumer products companies we follow, PG has milked cash from accounts payable by stretching payment terms on suppliers. The 9/20 quarter saw days payable rise YOY by almost 5 days to 120 although the figure declined sequentially indicating a levelling off in growth.

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Trade Accounts Payable	$11,935	$12,071	$10,464	$10,781
Cost of Products Sold	$9,142	$8,942	$8,716	$8,869
Days Payable	120.1	122.8	109.3	111.8

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Trade Accounts Payable	$10,951	$11,260	$10,207	$10,266
Cost of Products Sold	$8,723	$8,938	$8,427	$8,919
Days Payable	115.5	114.6	109.0	105.9

Management admitted in the 10-Q that cash flow benefitted to a degree from extended payment terms which we consider a very low-quality source of cash flow growth. We note that the smaller sequential decline in accounts payable in the 9/20 quarter versus the comparable year-ago periods accounted for about $170 million of the $570 million growth in cash from operations in the quarter.

Depreciation and Amortization Declining

(Concern level- LOW)

PG's depreciation and amortization declined despite net PPE and amortizable intangibles remaining essentially flat:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Depreciation & Amortization	$671	$814	$799	$677
Net PPE	$20,876	$20,692	$20,459	$21,250
Intangibles	$23,814	$23,792	$23,834	$23,980

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Depreciation & Amortization	$723	$820	$711	$650
Net PPE	$20,901	$21,271	$20,993	$20,822
Intangibles	$24,002	$24,215	$25,836	$25,947

While the company does not disclose depreciation expense, we know that amortization of intangible assets fell by about $10 million YOY, meaning the bulk of the decline in D&A came from depreciation. We saw no change in estimated depreciable lives in the 10-K and suspect the decline, which started in the 6/20 quarter, is traceable to certain assets becoming fully depreciated but remaining in service and thus not being removed from the net PPE figure. The YOY decline in the 9/20 quarter added about 1.6 cps to EPS growth which pales next to the earnings beat in the quarter, so we attach a low level of concern to the matter. However, PG has cut capital spending plans in the COVID environment which will likely reverse soon. Therefore, this mild tailwind could reverse at some point in the next few quarters as the company reaccelerates capital spending.

No Incremental Restructuring Charges

We were pleasantly surprised to see that the company did not make any non-GAAP adjustments to its reported earnings in the quarter other than for currency adjustments. PG has always been one of the worst offenders for taking never-ending restructuring charges and this is the first quarter in recent memory that GAAP earnings were not adjusted upwards by adding back "incremental" restructuring charges.

PG has a unique way of addressing its restructuring actions. It states in its SEC filings that:

"The Company has historically incurred an ongoing annual level of restructuring-type activities to maintain a competitive cost structure, including manufacturing and workforce optimization. Before-tax costs incurred under the ongoing program have generally ranged from $250 to $500 annually."

While it does not add back these "regular restructuring charges" to non-GAAP results. However, it does call them out in the MD&A and often mentions their impact on margin progressions. Our question has always been "if they are a regular part of business, why are they being called out at all?"

However, in addition to the ongoing charges, the company also conducts specific restructuring actions. The latest plan was announced in 2017. PG classified costs that were deemed to be a part of this restructuring action to be "incremental" and these amounts were added back to profits as a non-GAAP adjustment. The large size of these regular amounts coupled with the subjectivity of the process has, in our opinion, materially reduced the quality of the non-GAAP figures.

For perspective, the following table shows the components of restructuring charges as a percentage of non-GAAP earnings before taxes. These charges have been large relative to adjusted earnings with the percentage mix of ongoing versus incremental swinging wildly.

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Adjusted Net Income Attributable to PG	$4,277	$3,026	$3,058	$3,735
"Ongoing" Charges	$22	$136	$81	$88
Incremental Charges	$0	$226	$141	$17
Total Charges	$22	$362	$222	$105
Total Charges % of Adjusted Net Income	0.5%	12.0%	7.3%	2.8%

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Adjusted Net Income Attributable to PG	$3,623	$2,901	$2,789	$3,272
"Ongoing" Charges	$62	$160	$72	$100
Incremental Charges	$31	$164	$44	$77
Total Charges	$93	$324	$116	$177
Total Charges % of Adjusted Net Income	2.6%	11.2%	4.2%	5.4%

PG has been promising that the 2017 plan would be done at the end of 2020 and it appears this timeline has been met. This is the main factor in us raising our earnings quality rating. However, being the skeptics that we are, we are fully expecting the announcement of a new multi-year $100 million+ plan to be announced in the next couple of quarters.

Kimberly Clark (KMB) EQ Update- 9/20 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 are raising our earnings quality rating to 3+ (Minor Concern) from 3- (Minor Concern)

KMB's stock price took a beating after missing EPS targets in the 9/20 quarter by a penny. Strength continues in demand for at-home paper and personal care products, but the weakness in business spending was felt in the KC Professional segment.

Items that Deteriorated

- Our main issue with KMB is the ongoing restructuring charges that the company adds back to non-GAAP results. Charges increased to $0.31 cps in the quarter compared to non-GAAP EPS of $1.72- almost 20%. The 2018 restructuring plan is expected to run through 2021. In our mind, these regular charges erode the quality of adjusted earnings given the possibility of ongoing expenses being included in the charges and dismissed by those only watching non-GAAP results. The October acquisition of Softex could become an excuse for charges to expand. We note that the company already added back 3 cps of acquisition charges in the 9/20 quarter despite the deal not closing until October 1.
(Concern level: MEDIUM)

- Higher advertising was a drag on margins in the quarter. We have cited the company's low level of advertising in the past as a concern. This could continue to pose a problem in the future as the company combats the commodity-like nature of many of its products.
(Concern level: LOW)

Items that Improved

- Stock-based compensation increased by about 6 cps which was a material headwind and possibly a factor in the company falling short of EPS targets.

Items to Monitor

- KMB has not cut back capital spending as much as some companies have done during COVID. Nevertheless, free cash flow saw a massive boost from the infamous first-half rush on toilet paper. When conditions normalize, we expect free cash flow will again be insufficient to cover the dividend and the buyback.

- With the above point in mind, we are skeptical of the recently announced Softex acquisition for $1.6 billion. In normal conditions, KMB struggles to post positive organic growth. ***IF*** Softex represents the first step in a growth-through-acquisition binge which consumes cash, drives up debt, and brings the associated massive charge-offs and one-time charges, then quality could deteriorate rapidly.

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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