BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Sealed Air – 3Q20 Update
Maintain SELL

We still rate SEE as a SELL. The story remains much of the same – weak growth (negative with FX included) and giving guidance that is far off what the company actually experiences. Adjusted EPS of 82-cents has at least 17-cents from unexpected items or items that shouldn't be added back.

- **Price/Cost spread added to earnings again.** SEE has contracts with customers that allow it to recover cost inflation. It also means cost deflation should also lower prices. The result is the company is expected to net to zero over time in terms income coming from favorable raw material costs.

  SEE came into 2020 saying that after windfall profits from price/cost throughout 2019 –investors should expect a negative swing in this area of $70 million in 2020. It warned again on the 3Q call that it is guiding to negative price/cost starting in 4Q20. We shall see about that guidance – but the problem is the longer this rubber band is stretched – the more it should correct in the future. This has been a key source of EPS and EBITDA growth:

	3Q20	2Q20	1Q20
Price Cost	$9	$19	$7
EPS Boost	**$0.05**	**$0.08**	**$0.04**
Total EBITDA Gain	$18	$23	$37
Due to Price/Cost	$9	$19	$7
Due to Acquisition	$4	$14	$13

- **The company guided to a 27% tax rate coming into 2020. In 1Q, they enjoyed a lower tax rate by realizing $10 million in tax settlements that were not in guidance**. They guided to 27% after 2Q. **3Q saw a large drop in tax rate due to changes in US tax rates regarding low-taxed foreign earnings. That added 8-cents to EPS for 3Q20 and was not guided to or announced during the quarter**. After two drops, the company is guiding to 26% for a tax rate for 2020 now. The dispute with the IRS to disallow a $1.49 billion tax deduction has still not been resolved and no further guidance was given by SEE other than to say it may be resolved within 12-months.

- **There still isn't much growth at all here.** We have been pointing out that for a company that supplies industries in the fresh food business and e-commerce – it simply isn't growing:

	North Am	EMEA	APAC	total pre-S.Am	S. Am	Total
2019 Sales	$729.4	$250.0	$180.8	$1,160.2	$58.3	$1,218.5
Price gain	-$10.8	$0.9	-$0.1	-$10.0	$9.3	-$0.7
Volume gain	$12.9	-$5.7	$2.3	$9.5	-$1.8	$7.7
2020 Sales	$731.5	$245.2	$183.0	$1,159.7	$65.8	$1,225.5
Org Growth y/y	0.3%	-1.9%	1.2%	**0.0%**	**12.9%**	0.6%
FX $ impact	-$5.3	$5.9	$3.8	$4.4	-$16.8	-$12.4
2020 Growth with FX	-$3.2	$1.1	$6.0	$3.9	-$9.3	-$5.4
Actual Growth %	-0.4%	0.4%	3.3%	**0.3%**	**-16.0%**	**-0.4%**

The basics of this table are that SEE has zero organic growth without adding in South America where price hikes are huge. However, the reason South America has high

pricing power is because it loses almost twice as much on FX. In reality, South America is a negative growth story.

So, here is another zero on growth for 3Q20. It is -2.4% for the 9 months of 2020. We actually think this is worse considering how many people are eating at home and how much grocery sales have soared. Plus, think how many people are ordering even toothpaste and paper towels in the mail. Looking at the table above under price/cost – it is clear that EBITDA growth is not being driven by organic growth. It even had a surge in demand at the end of 1Q as customers stocked up on packaging supplies.

- **SEE continues to add back its FX hits to Adjusted EPS as well as third party consulting fees – both of which occur essentially every quarter:**

Adjustments to Income	3Q20	2Q20	1Q20
3rd Party Consultants	$7.2	$3.8	$4.0
FX impacts	$1.1	$1.2	$0.9

For 3Q20 – here was another recurring 4.3 cents that SEE added back to adjusted earnings. If we remove that from their adjustments along with the 8-cents in tax issues they didn't guide to and the 5-cents in Price/Cost issues they said would be a drag, not a gain – we get adjusted EPS of 65-cents for 3Q20. That compares to estimates of 66-cents and prior year EPS of 64-cents and they gained 2-cents from an acquisition for 3Q20 in the past year too.

- **Guidance for 2020 was raised but not due to business improving. SEE raised Free Cash Flow guidance from $375 million to $450 million.**

    - $30 million comes from the tax rebates related to 3Q changes
    - $15 million comes from cutting the forecast on capital spending
    - $15 million comes from cutting the cash spending on their restructuring plan
    - $6 million comes from a 1% cut in the forecasted tax rate

Ares Capital Corp (ARCC)- 3Q20 Update
Maintain BUY

We are maintaining our BUY recommendation on ARCC. The company beat forecasts by 1-cent, with 39-cents of core EPS. It saw its portfolio value recover to $14.4 billion vs. $14.4 billion pre-COVID for 4Q19. We still see levers available to drive EPS higher. ARCC is sitting at Debt/Equity of 1.10x. ARCC can get to 1.25x. Every 0.05x addition is worth about 1.1-cents per quarter in core EPS. Also, the yield can improve further. Every 10bp of net yield is worth 0.9-cents in core EPS per quarter.

- **The Libor Floors are kicking in for yield.** ARCC has an average of 1.1% floors on its floating rate investments. Floating rate is 83% of the portfolio and 70% overall has a Libor Floor, which is currently at 22-bp. Plus, newer loans have been made at higher spreads and some of existing portfolio saw adjustments that boosted rates. **Average yield on the portfolio ticked up 20bp on 3Q vs 2Q and 1Q. They are getting better yield on new deals on companies with lower leverage to EBITDA.**

- **The portfolio value is recovering. Much of their focus has been in growth areas like software and health care. In the quarter, portfolio companies moving up in the ranking scale out-numbered declining securities 3:1.** Other stats point to improvement as well:

  - **99% of contractual interest due was collected in the quarter** – investors in these deals have backed the companies who owe ARCC where needed.

  - **Liquidity has continued to improve** as more companies in the portfolio have paid down their revolvers with ARCC:

	3Q20	2Q20	1Q20	4Q19
Revolvers Available	$2,002	$1,945	$2,083	$2,009
Revolvers Drawn	$534	$685	$921	$460

  - **The number of new amendments fell 60% in 3Q from 2Q**. These 3Q amendments were characterized as less serious issues by the CEO. Also, the

CEO noted that he believes ARCC has identified and addressed all the companies with COVID/Economic problems.

  - Their larger companies are showing greater earnings stability and **the market has switched from risk management to growth opportunities for these businesses**.

- **Two earnings trends that move inverse to each other could become more of an earnings tailwind going forward.**

  - **When the economy is slow and there are more loans that require amendment – ARCC sees its "other income" increase clients pay additional fees.** In most quarters this is about $7-$8 million or 1.9-cents in EPS. In 3Q, it was $23 million or 5.4-cents in EPS – or what should be an unsustainable 3.5-cents in EPS.

  - **Moving inversely to this income source is "capital structuring fees" which occur with new loan commitments.** These rise when ARCC is making more loans and are generally about 1.8% of new loans. These can be $40 million per quarter or 9.5 cents in EPS. In 3Q, these fees amounted to only $12 million or 2.8 cents in EPS, for a 6.7-cent headwind.

  - **Net/net – ARCC EPS suffered by more than 3-cents in the give-n-take of these two income sources and still beat forecasts in 3Q**.

  - With new loan activity at less than one-third 2019 levels in 3Q at $706 million vs. $2.4 billion in 3Q19, ARCC is talking about new deals picking up. In the first 21 days of 4Q, it had commitments for $409 million of new loans. They appear on pace to exceed 3Q levels and that could boost capital fees as adjustment fees decline.

Keurig Dr Pepper (KDP) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

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

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

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

We are maintaining our earnings quality EQ rating of 2- (Weak) on KDP

3Q20 continues to reflect many of the problems we have seen in the past. **Adjusted EPS of $0.39 beat forecasts by 2-cents. We would argue with over 5-cents of EPS:** 2.4 cents from what KDP calls COVID-pay to employees, 0.6 cents from a lower tax rate, and it cut marketing in every unit but did not quantify it. **Every 1% of sales that marketing fell added 1.6-cents back.** Its new lease payments seem to change start dates often too. Some were expected to commence in 3Q20, but lease payments were flat in the period. We estimate that these leases will eventually cost about 0.8-cents in EPS per quarter. They were supposed to have begun in 1Q20, then 2Q20, and then 3Q20.

KDP also guided down. Sales for 3Q grew at 5.8% and for 9-months by 4.4%. Guidance for 2020 is 3-4%. Adjusted EPS for 3Q grew by 22% and for 9-months by 16%. Guidance for 2020 is 13%-15%. **It is admitted that some coffee sales were pulled forward into 3Q.**

What got worse?

- Payables grew by another $140 million and stand at 239 days.
- Adjusting for only $2.5 billion of the payables that are factored and structured payables – KDP's actual Debt/EBITDA is 4.5x vs the reported 3.8x.
- In 2Q, KDP said it cut marketing in 3 of the units. In 3Q, all 4 units had lower marketing – but KDP will not quantify this.

- The size of marketing should make reported cuts a meaningful part of EPS growth of late.

- Free Cash Flow is likely overstated by the amount payables grew and the amount marketing fell and drops in cap-ex. We estimate that reported free cash flow of $525 million was closer to $330 million.

What still concerns us?

- When do the new leases kick in from sale-leaseback deals. Each quarter this year, KDP has projected these commence next quarter – yet so far lease expense is flat.

- The dollar amount of new leases will nearly double lease obligations so this should become a headwind to EPS and is another area where KDP essentially moved debt.

- KDP has a Latin American FX issue still – it is reporting growth in that region without FX but being realistic that it is a recurring item – real growth is falling double digits.

- The amount of adjustments to earnings continues to be high. KDP is now adding back part of the pay of employees as one-time COVID charges. In 3Q this was 2.4-cents in EPS. Will they actually see pay decline going forward?

Where Is the New Lease Expense?

We noted several quarters ago that KDP completed a series of sale-leaseback transactions. This is part of why we argue that KDP has not been paying down its debt. It's simply refinancing it into other areas that don't get counted as debt on the Bloomberg screen. Selling assets to retire debt but taking on new operating leases fits that process – especially since KDP touts adjusted EBITDA not EBITDA + Rent. We estimate that the new operating leases will add to lease expense by about $10-$15 million per quarter and reduce EPS by 0.6-0.8 cents per Q.

For each quarter of 2020, the operating lease payment has been constant at $28 million. Yet here is the what the footnote says after each quarter under a heading of *"Significant Leases That Have Not Yet Commenced:"*

> **1Q20:** Estimated aggregate future lease payments of $610 million **commencing in 2Q20 and 2Q21.**
>
> **2Q20:** Estimated aggregate future lease payments of $670 million **commencing in 3Q20 and 1Q21.**
>
> **3Q20:** Estimated aggregate future lease payments of $640 million **commencing in 4Q20 and 3Q21.**

Thus, these new payments were supposed to start in 2Q and apparently did not, then in 3Q and apparently did not, and now 4Q – where we shall see. It does NOT add in these future payments when evaluating total future lease payments until payments have begun. At the end of 3Q20 – Total future lease payments were $852 million. They are going to add $640 million to that figure soon. Thus, we think lease expense should see an increase from the flat $28 million per quarter seen the last 3-quarters. In 2018, future lease payments were $312 million.

Payables Rose AGAIN

KDP has touted that it delays payment to vendors for as long as 360 days – which shatters any figure we've ever seen for a company dealing in some basic commodities like PET, sugar, coffee, cardboard, and aluminum. This is the other area where we believe KDP is refinancing its debt and putting into working capital where it doesn't show up on the computer screen.

Payables are now up to $3.5 billion, which is up $140 million from 2Q and up $341 million from 4Q. DSPs are at 239 days up from 219 days a year ago. Amazingly that is down 7 days from 2Q20 as stronger sales helped COGS rise and lower the ratio.

Keep in mind, $2.5 billion of the payables are factored with short-term financing. If KDP runs into trouble on debt or liquidity – they could become due very quickly. That's why we would add $2.5 billion to the company's stated debt figure (along with the structured payable which is $160 million) when calculating its Debt/EBITDA figure.

The company says Debt/EBITDA is only 3.8x now. We would argue adding back $2.66 billion in payables that are essentially short-term back financing would make the real ratio 4.54x. It can get to 4.7x if you don't let them adjust EBITDA for all their COVID costs. That still doesn't adjust for the sale leasebacks. KDP is carrying much more debt than the computer screen shows.

KDP Will Not Quantify How Much It Cut Marketing in the Quarter

We know that marketing in 2019 was 6% of sales and it hits in SG&A. With COVID, KDP has reduced marketing – which we can understand. There's no reason to spend heavily when parts of the end markets are closed or when other markets are seeing strong demand from people staying at home.

What is problematic in our opinion is KDP can tell investors how many additional boxes of tissues they bought, how much extra they spent to sanitize restrooms, what were non-routine legal costs and call all that out as specific one-time items investors should add back to adjusted EPS. However, after telling investors that it cut spending on marketing in all four units in 3Q, and touting even though gross margin fell 120bp, a 380bp improvement in SG&A more than offset that – KDP cannot quantify what happened to an expense that was likely $175 million the prior year. Here was the answer to "can you talk about marketing levels in the quarter, how that stood year-over-year…"

> *"Yet, **we also delivered a substantial reduction in our overhead base that includes overall sales, marketing and general administrative overheads** via a series of the base productivity programs and merger synergies that came in a very substantial manner that helped us to reduce our overall cost structure.*
>
> ***In that SG&A number, we also include and categorize our advertisement and promotion investments. So whenever the return on investment in advertisement and promotion didn't make sense, we also reduced that spend due to the COVID-19 environment**. So you see it's a combination of the factors and the things and mostly on the positive side that helped us to drive and further expand our OI margin by 260 basis points, which is quite substantial."*

Here's what we do know, Adjusted SG&A fell by $78 million y/y from $889 million to $811 million. That's a 9% decline. Every 100bp of lower marketing was worth $30 million of that decline or 1.6 cents of EPS. It would not surprise us if it was closer to 2.0-2.5-cents of EPS because one of the headwinds KDP is calling out for 4Q is marketing should increase and they are forecasting lower EPS growth for 4Q. We think this is a big part of the EPS beat and they have benefited from higher sales and lower costs - both of which are expected to normalize.

How Much of the $525 million of Free Cash Flow is Sustainable?

As always, KDP likes to tout free cash flow to show that it can pay down debt and meet its cash needs. Cash from Operations was $604 million. We know $140 million of that came from stretching payables again. We also know cutting marketing probably added between $24-$48 million (net of taxes) to operating cash flow too. On top of that, the lease expense that didn't hit likely added another $8-$12 million. Then, we know principal payments on finance leases were $11 million in the quarter.

If we add that up, sustainable operating cash flow was probably closer to $400-$410 million. Free Cash Flow also benefited from capital spending falling from $90 million a year ago to $80 million. That makes Free Cash flow probably closer to $320-$330 million rather than $525 million.

Dow Inc. (DOW) 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 maintaining our rating of 3+ (Minor Concern)

DOW beat forecasts by 19-cents with adjusted EPS of $0.50. We are not overly impressed with the quarter's quality. First, DOW has been writing off its Sadara JV investment to the tune of billions of dollars. It is still committed to lending it more money to retire existing debt at Sadara. All the on-going write-offs were added back as one-time adjustments. Suddenly in 3Q, Dow reports a $104 million swing in y/y earnings from Sadara – which was worth about 11-cents in the quarter. While we understand COVID caused a short-term slowdown, we are also disappointed to see Dow report a new $617 million restructuring charge. This follows years of restructuring already and appears to cover areas that should have been part of past major overhauls of the business.

What got worse:

- A new restructuring charge amid COVID – but it comes after 5-years of heavy restructuring already and impacted some facilities that probably shouldn't have survived the past work.

- Sadara's refinancing still hasn't happened and DOW is on pace to send it another $400 million this year.

What got better:

- Sadara posted a profit in 3Q and generated an 11-cent swing for EPS based on tighter inventory situations helping out.

- Liquidity looks solid with low debt maturities through 2023.

- The list of other adjustments to EPS showed improvement with lower integration charges for the prior restructuring, a one-time gain, and early extinguishment of debt.

What to keep watching:

- If Sadara can be refinanced, it may stop the cash contributions from DOW to that JV and will remove the $3.8 billion debt guarantee DOW has on the JV's debt.

- Can Sadara earn money in more than one quarter?

- Does the latest restructuring move some wages up to a year in advance into the one-time charge being adjusted back?

- Over half the charge was related to severance and DOW expects to save $300 in costs, both only half the savings are forecast by mid-2021 and the rest by the end of 2021. We would expect COVID-related layoffs to happen very quickly not late in 2021.

Sadara Is Still Not Over – But May Be Soon

As a quick review, Sadara is a JV between DOW and the Saudi Arabian Oil Company. DOW sells Sadara products outside the Middle East for a fee.

- In 2017, DOW loaned the JV $735 million – but later converted it into equity.

- In 2018, DOW converted $382 million of JV Notes and Receivables into equity.

- In 2019, DOW loaned the JV another $473 million and converted $380 million of JV Notes and Receivables into equity.

We know DOW was making money by selling Sadara product – but it did not seem to be fully collecting the fees if it was running receivables with Sadara and then converting them to equity. That was especially true when at the end of 2019, DOW took a $1.755 billion impairment against its Sadara investment and wrote the value to zero. That impairment was added back as a one-time item, but it should have included some of the earnings DOW booked during 2018 and 2019 when the receivables were converted to equity.

In 2020, the JV has been carried at a negative value on DOW's balance sheet. It has continued to lend it new money to fund the business and allow it to retire other debts. The JV lost money in 1Q and 2Q. Suddenly the tide turns for 3Q during COVID?

Eq Income	3Q20	3Q19	2Q20	2Q19	1Q20	1Q19
Income	$60	-$44	-$95	-$15	-$89	-$14
Loans made	$44		$122		$114	
Carrying Value	-$103		-$105		-$92	

The reason given on the call was Sadara was able to take advantage of tight inventories and post better margins. We're not certain if that will repeat for long. The history is Sadara has had a tough time. We know Sadara was posting losses in 1Q and 2Q and suddenly had a $104 million y/y improvement in 3Q. That is worth as much as 11-cents in EPS and we are skeptical about sustainability given the past results. Also, DOW expects it may lend Sadara up to $400 million this year and has so far given $280 million in loans. Another positive is the $400 million estimate is down from $500 million earlier this year.

Finally, DOW still guarantees $3.8 billion in Sadara debt. The JV has finished several steps in project completion, which will enable Sadara to refinance its short-term debt with longer maturities. The refinancing would remove the debt where DOW has the guarantee. The operational testing was complete in December 2018. The remaining tests for Sadara to refinance without DOW were expected to be completed early in 2020. It's October and the company now says before December 2020 it should happen.

The goal is to get Sadara refinanced so DOW does not have to continually lend it more money every year. It would still recognize its share of Sadara losses and profits quarterly.

We are not certain that one profitable quarter amid tight inventories in the market is indicative of Sadara's future success. The company even noted that Sadara is still performing below average. We would think the remaining risks would be:

- Can Sadara fully refinance? Will banks/markets not value the company at a high enough level to justify the full amount expected. Will DOW have to cover some additional shortfall?

- If Sadara's margins and income remain weak, will DOW have to continue to support it perhaps by forgiving more receivables?

- DOW has an incentive to continue the JV – it earns a fee to market the products from Sadara. Sadara has been about 8%-9% of DOW Cost of Sales. It should be a generating income and a decent amount of sales for DOW too that occur in normal operations – not solely in the equity income from nonconsolidated affiliates.

Another Restructuring Charge and Boost to Accruals?

DOW went through a restructuring prior to merging with DuPont. The two companies divested more units and combined their two businesses into three separate units and restructured those. Many charges involved optimizing the footprint for manufacturing and cutting the workforce. In just the last 3-years, DOW has taken $6.2 billion of restructuring charges, impairments, and asset write-offs. Prior to that, it had charges of over $800 million in 2015-16.

In our original review, we praised DOW that the restructurings were over and the remaining integration charges were getting smaller – falling from $1 billion in 2019 to about $250 million in 2020 and would end. Thus, we were disappointed to see a new $575 million charge in 3Q20 as DOW eliminates some smaller uncompetitive facilities and lays off about 6% of the work-force. The question we always have is, "How were any uncompetitive facilities missed in the prior 5-years of massive restructuring?"

What also is questionable to us is laying people off generally means savings happen immediately. This charge has $297 million related to severance. It took the full charge in 3Q20 and added it back as a one-time item. However, the expected cost savings are forecast at $300 million per year with only half of that realized by mid-2021 and the rest by the end of 2021. So. are the employees going to remain in place for several more quarters? Are there some future wages in this restructuring charge that are being added back? That could inflate future earnings.

The wage aspect of the charge is about $0.32 per share that was added back to adjusted EPS. It also was added to accrued expenses. DOW notes that $166 million was added to "accrued and other current liabilities" and $211 million was added to "other noncurrent obligations." That should indicate much of this is going to be charged against reserves in more than a year. We know that's not the $197 million asset write-down as that has already been charged off against the reserve.

We have already voiced a concern that accrued liabilities and other noncurrent obligations have been rising at DOW. It has worsened in 2020:

Accruals	3Q20	2Q20	1Q20	2019	2018
Accrued Exp.	$3,408	$2,731	$2,811	$2,762	$2,732
Other N/C Obligations	$7,497	$7,404	$6,937	$6,547	$4,709

In our original EQ report, we talked about how DOW took a $399 million environmental charge in 2019 and added it back to EPS. The charge was accrued. In 2020, it added $56 million more to cover the facilities it will close to accruals. The other noncurrent obligations continue to rise this year. The current accruals didn't move much until 3Q and it seems to be wage and severance related as we found the following note in the 10-Q:

> *"Accrued and other current liabilities" were $3,408 million and $2,784 million at September 30, 2020 and $2,762 million and $2,233 million at December 31, 2019, for Dow Inc. and TDCC, respectively.* ***Accrued payroll, which is a component of "Accrued and other current liabilities" and includes liabilities related to payroll, incentive compensation and severance, was $677 million at September 30, 2020 and $284 million*** *at December 31, 2019."*

The danger of high and rising accruals is they can be reversed in future periods and help EPS. We will continue to monitor this.

With the exception of the new restructuring charge – the rest of the adjustments to EPS look cleaner for 3Q20:

	3Q20
GAAP EPS	-$0.04
Integration	-$0.06
Gain on asset sale	$0.26
Loss on early Exiting Debt	-$0.07
Restructuring	-$0.67
Adjusted EPS	$0.50

The list is much shorter and the integration charge continues to get smaller y/y. We see those as positives. The gain on selling railroad facilities is one-time and should be added back. Retiring debt early is not something we see as a bad thing either.

Liquidity Remains Strong, Inventories May Need to Rise

Coming out of 3Q, DOW had $4.5 billion in cash on hand and no debt maturities in 2020 remaining. Maturities range from $121-$250 million for 2021-23.

We would expect lower capital spending in 2020 to bounce back next year, but DOW is on pace to have free cash flow > $4 billion this year.

Inventories dropped in DSIs by 8 days sequentially and 4 days y/y. A $300-$400 million increase in inventory may be a drag on cash flow going forward may be necessary. Inventory declines added to cash flow by $540 million in 2Q and $158 million in 3Q. Some of that is lower commodity prices too.

Snap-on (SNA) Update- 9/20 Qtr. Cancel SELL, Initiate EQ Coverage

Current EQ Rating*	Previous EQ Rating
4+	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

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We are canceling our SELL rating on SNA and initiating earnings quality coverage with a rating of 4+ (Acceptable)

Our initial warning on SNA focused on the company driving sales growth with the extension of credit to its franchisees and their customers. In addition, the company has faced secular headwinds from new cars requiring less maintenance, the industry shift away from "mom-and-pop" shops, and the budding move towards electric vehicles. COVID has resulted in a change (likely temporary) to the outlook for driving. People are working from home more, are taking driving vacations closer to home rather than flying, and are considering a move to the suburbs. These trends are boosting miles driven and could boost business at auto shops. However, investors should remember that the SNA value proposition remains tied to the extension of credit to both franchisees and their customers. The average yield on finance receivables is north of 17%, indicating that many of these customers would not be able to get credit anywhere else.

Going forward, we will focus on SNA's earnings quality which will include special attention paid to credit trends.

- Contract and finance receivable days of sales both fell YOY, ending a long string of material YOY increases. Originations were down slightly despite an almost 10% increase in Tool Group and Repair System revenues indicating sales growth was not driven by credit extension. The increase in cash sales could be an indication of a quick recovery in repair business but the impact of stimulus payments should not be ruled out.

- Delinquency rates for contract and finance receivables both improved versus the year-ago period despite payment support returning to a normal level and payments from deferred payment plans offered through June likely coming due. Recall that delinquency rates received an artificial benefit from both items in the June quarter.

Extension of Credit Slowed

SNA's originations were $252.8 million in the quarter, down slightly from the year-ago levels despite a 9.5% increase in Tool Group and Repair Systems revenue. This ended a long string of significant increases in contract receivable days and finance receivable days of sales as shown below:

Contract Receivable Days of Sales	9/26/2020	6/27/2020	3/28/2020	12/28/2019
Tool Group + Repair Systems Sales	$705.9	$519.8	$625.2	$686.5
Total Contract Receivables	$480.5	$464.6	$447.6	$460.8
Total Contract Receivables Days	62.1	81.6	65.3	61.2

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Tool Group + Repair Systems Sales	$644.8	$688.3	$672.2	$682.5
Total Contract Receivables	$451.3	$439.0	$438.0	$443.2
Total Contract Receivables Days	63.9	58.2	59.5	59.3

Finance Receivable Days of Sales	9/26/2020	6/27/2020	3/28/2020	12/28/2019
Tool Group + Repair Systems Sales	$705.9	$519.8	$625.2	$686.5
Total Finance Receivables	$1,654.4	$1,648.8	$1,616.2	$1,633.6
Total Finance Receivables Days	213.9	289.4	235.9	217.1

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Tool Group + Repair Systems Sales	$644.8	$688.3	$672.2	$682.5
Total Finance Receivables	$1,618.2	$1,618.0	$1,603.0	$1,592.9
Total Finance Receivables Days	229.0	214.5	217.6	213.0

We view this as a positive indication that the company has not pushed sales to customers and franchisees through aggressive credit extension. This could be an indication of a quick recovery in business at auto shops, but it can't be ruled out that the increase in cash sales was impacted by stimulus payments and could prove to be short-lived.

Credit Metrics Improved Noticeably Even Without Payment Relief

We noted in our last review that credit metrics improved artificially due to the company extending short-term payment relief with forbearance at 2.5% of the portfolio compared to a historical norm of 1%. In addition, SNA offered 60-day deferred payments plans that ran through June to support revenue in the second quarter. However, we also noted it was possible that increasing miles driven could support repair businesses enough for them to service their loans. This appears to have been the case as delinquency rates for contract and finances receivables fell YOY in the 9/20 quarter:

Contract Receivables	9/26/2020	6/27/2020	3/28/2020	12/28/2019
30-59 days past due	0.27%	0.25%	0.39%	0.32%
60-90 days past due	0.10%	0.15%	0.20%	0.19%
>90 days past due	0.27%	0.36%	0.31%	0.32%
Total past due	0.63%	0.76%	0.90%	0.84%
>90 Days and Still Accruing	0.06%	0.06%	0.09%	0.11%

Contract Receivables	9/28/2019	6/29/2019	3/30/2019	12/29/2018
30-59 days past due	0.33%	0.29%	0.29%	0.38%
60-90 days past due	0.22%	0.23%	0.20%	0.27%
>90 days past due	0.35%	0.32%	0.32%	1.16%
Total past due	0.90%	0.83%	0.81%	1.81%
>90 Days and Still Accruing	0.04%	0.07%	0.09%	0.04%

Finance Receivables	9/26/2020	6/27/2020	3/28/2020	12/28/2019
30-59 days past due	1.03%	0.55%	1.07%	1.16%
60-90 days past due	0.65%	0.29%	0.68%	0.71%
>90 days past due	0.97%	0.90%	1.23%	1.26%
Total past due	2.65%	1.74%	2.98%	3.13%
>90 Days and Still Accruing	0.80%	0.70%	0.97%	1.01%

Finance Receivables	09/28/2019	06/29/2019	03/30/2019	12/29/2018
30-59 days past due	1.07%	0.95%	0.85%	1.17%
60-90 days past due	0.67%	0.61%	0.58%	0.73%
>90 days past due	1.19%	0.97%	1.17%	1.23%
Total past due	2.92%	2.53%	2.60%	3.13%
>90 Days and Still Accruing	0.93%	0.75%	0.90%	0.96%

Despite the removal of payment support and payments on the deferred payment plans kicking in, total delinquency rates for both contract receivables and finance receivables were lower than they were in the comparable year-ago (pre-COVID) quarter.

We will continue to monitor the credit portfolio for signs of aggressive credit extension or deterioration in outstanding loans.

Microsoft (MSFT) EQ Update- 9/20 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)

MSFT reported EPS in the 9/20 quarter of $1.82, 27 cps ahead of the consensus estimate. Revenue of $37.2 billion was roughly $1.4 billion ahead of expectations.

Items that Deteriorated

- Deferred revenue days of sales for the Intelligent Cloud segment continues to decline YOY. We have addressed in past reviews how this is due to the shift towards hybrid cloud contracts in which a component is booked upfront with much of the value tied up in services. These are billed as used and therefore do not result in a buildup of unearned revenue. Continued growth in the RPO (remaining performance obligation) tempers our concern and prevents us from moving the rating to a 3 (Minor Concern). However, we note that the unearned revenue balance has declined YOY on an absolute basis for two straight quarters which is increasing our level of concern.
  (Concern level: MEDIUM)

- The effective tax rate fell to 13.8% in the quarter, below the 16% rate forecast in the company's outlook for the period due to a higher than expected benefit from options. This would have added about 4.5 cps to earnings in the quarter, only a fraction of the reported EPS beat. (Concern level: LOW)

Items to Monitor

- As noted in our previous review, the company extended its estimated depreciable useful lives for server and network equipment effective in the 9/20 quarter. This added 10 cps to EPS in the period. In addition, gross margin would have declined in the quarter rather than the reported 500 bp increase without this non-operational benefit. The company has discussed this prominently in its conference calls and disclosed the exact benefit of the change in the notes of its 10-Q. We therefore assume it has been accounted for in analysts' models.

Deferred Revenue Days Continue to Decline

(Concern level: MEDIUM)

We have documented before that MSFT's deferred revenue in its Intelligent Cloud Segment is declining relative to segment revenues. Intelligent Cloud includes the key *Azure* cloud computing infrastructure and services business. These cloud computing solutions contain components that are recognized upfront as well as service components that are recognized on a usage basis. In addition, the trend has been towards larger, longer-term hybrid cloud contracts. The contracts do not bill much of the total value for the services upfront, so the total value of bookings can increase without a commensurate increase in unearned revenue. Large contracts with some components being recognized upfront and services being paid "as you go" has led to revenue outrunning unearned revenue for several quarters in the Intelligent Cloud segment. As a result, deferred revenue days of sales have been declining for some time and this continued into the 9/20 quarter as seen in the table below:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Intelligent Cloud Revenue	$12,986	$13,371	$12,281	$11,869
Intelligent Cloud Unearned Revenue	$15,039	$16,620	$12,984	$13,766
Intelligent Cloud Def. Rev Days	106.5	113.1	96.2	106.7

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Intelligent Cloud Revenue	$10,845	$11,391	$9,649	$9,378
Intelligent Cloud Unearned Revenue	$15,255	$16,988	$12,531	$12,551
Intelligent Cloud Def. Rev Days	129.4	135.7	116.9	123.1

Not only did deferred revenue days decline by 22 versus the year-ago quarter, deferred revenue has declined on an absolute basis as well.

It is worth noting that the company's outlook for Intelligent Cloud revenue in the 12/20 quarter is a noticeable deceleration from past quarters. The mid-point of the company's guidance was for Intelligent Cloud revenue of $13.675 billion which represents 15% YOY growth. The below table puts this in perspective with previous quarters:

	12/2020 E	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Intelligent Cloud Rev. Growth	15.2%	19.7%	17.4%	27.3%	26.6%	26.6%

The main item that has prevented us from assigning a higher level of concern to the decline in deferred revenue days is that fact that bookings remain strong and the, remaining performance obligation (RPO) which is the total of unearned revenue and amounts under contract that have yet to be recognized or received has not decelerated. The following table shows a breakout of the two components of RPO:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Remaining Performance Obligations	$111,000	$111,000	$93,000	$93,000
Total Unearned Revenue	$36,305	$39,180	$30,397	$31,221
Amt. to Be Recognized in Future	$74,695	$71,820	$62,603	$61,779
Amt. Recognized in the Future % of RPO	67%	65%	67%	66%

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Remaining Performance Obligations	$89,000	$91,000	$75,000	$72,000
Total Unearned Revenue	$34,026	$37,206	$28,135	$28,084
Amt. to Be Recognized in Future	$54,974	$53,794	$46,865	$43,916
Amt. Recognized in the Future % of RPO	62%	59%	62%	61%

We see first that total RPO is growing almost 25% YOY which is on par with the growth seen in the previous three quarters. Second, we notice that the portion of RPO attributable to amounts that are under contract but have yet to be invoiced and recorded in unearned revenue is increasing. This fits with the company's narrative that it is signing up longer-term contracts.

Still, we note that the fact that Intelligent Cloud unearned revenue declined YOY on an absolute basis for the last two quarters is increasing our level of concern in this area and we will continue to monitor this issue moving forward.

Danaher (DHR) EQ Update- 9/20 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)

DHR closed the Cytiva deal on March 30, 2020. The timing of the deal proved to be beneficial as conditions in the Life Sciences market have been supercharged in the current COVID environment, growing more than 35% in the quarter. This helped drive non-GAAP EPS to $1.72 in the quarter, 36 cps ahead of estimates.

We continue to rate DHR's earnings quality as Acceptable, but visibility has been clouded due the Cytiva deal and now the unusual growth it is providing. We expect to get a clearer picture in the quarters ahead.

Items that Deteriorated

- DHR closed the Cytiva deal on March 30, 2020. Of the $20.7 billion purchase price, $10.2 billion was booked as goodwill and therefore is not amortized. Another $10.7 billion was booked as intangible assets consisting largely of developed technology, customer relationships, and trade names which are being amortized over an average life of 17 years. However, the company adds this amortization back to its non-GAAP earnings figures. In the 12/20 quarter, pretax amortization of 45 cps (approximately 36 cps after tax) compared to non-GAAP earnings of $1.72. We disagree with the principal of ignoring the cost of acquisitions by disregarding amortization expense. (Concern level: MEDIUM)

- Non-GAAP adjustments included a 31 cps pretax charge from acquisition-related fair value adjustments to inventory and deferred revenue, incremental transaction

costs, and integration preparations costs. This is the first sizeable charge related to the deal which closed in the 4/3/20 quarter. Given the size and scope of the acquisition, we are not overly concerned by the charge and therefore assign it a small level of concern. Should future quarters feature continuing integration charges, we will become more skeptical.
(Concern level: LOW)

Other Items

- On a housekeeping level, we observe that the company only provides a breakout of non-GAAP impacts on a per share basis. Many companies include a breakout of items by expense line and the overwhelming majority at least on operating income and net income levels. We believe a more detailed non-GAAP disclosure would be very helpful to analysts.

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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