BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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www.btnresearch.com

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Macquarie Infrastructure Corp – 3Q20 Update Maintain BUY

We are maintaining our Buy recommendation on MIC after it announced it has reached an agreement to sell its IMTT (storage tank) unit. We had estimated it was worth $2.6 billion and the final sale came in at $2.685 billion. That business is healthy with inventories high and all the capacity that came up for renewal was completed at a higher rate. The sale is expected to close in 4Q20 or early 1Q21. We think the rest of the company brings the total value per share net of debt to about $45 and it is expected to be unlocked within a year. See our April 2020 report for more details of how we arrive at that figure:

- **The key parts to this sale are that MIC will effectively retire all parent company debt - $400 million in convertible bonds.** There is $150 million drawn on the revolver but there is more than enough cash on hand to repay that too. **Second, shareholders will be paid a $10.75 per share dividend.**

- **Atlantic Aviation posted EBITDA of $54 million vs. $17 million in 2Q and Free Cash Flow was $39 million vs. $42 million y/y.** They are forecasting EBITDA for 2020 of

$185-195 million vs. $276 million in 2019, they are seeing steady improvement as flying resumes.

- **The Hawaiian gas company has improved as Hawaii relaxed its quarantine issues.** EBITDA of $7 million matched 2Q and the company is free cash positive at $4 million for the quarter. Guidance is for $35-$40 million of EBITDA vs $60 million in 2019. As travel to Hawaii recovers, it should see a return to normal operations.

- **MIC expects that the gas utility will be sold next. It is smaller and would take about a year to go through the Public Utility Commission**. We estimate that this business is worth about $600 million, which is 10x the $60 million in EBITDA it regularly produces. It has under $200 million debt and is **worth about $4.50 per share** in our view.

- **That leaves Atlantic and if not sold, MIC speculated on the 2Q call that it would likely acquire the parent company and become effectively spun-off to shareholders as a pure-play of airport assets. <u>Management has a financial incentive to complete all of this by January 1, 2022.</u>**

- **At $30 per share, we see $10.75 and $4.50 net of debt for IMTT and Mic Hawaii. That values Aviation at $14.75 per share.** Normal operations are $276 million in EBITDA growing about 4%-5%. **The market is valuing that at 8.3x EBITDA. Airport assets trade at more than 20x EBITDA.** Atlantic Aviation has long-term concessions at airports to provide fuel, hanger space, catering, cleaning, de-icing… That would be tough to duplicate. If aviation is valued at 10-15x EBITDA – here is what the stock could be worth:

EBITDA Multiple	10.0	11.0	12.0	13.0	14.0	15.0
Value of Atlantic	$2,760	$3,036	$3,312	$3,588	$3,864	$4,140
Less Atlantic Debt	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Value to MIC Shares	$1,760	$2,036	$2,312	$2,588	$2,864	$3,140
Per share	$20.2	$23.3	$26.5	$29.7	$32.8	$36.0
Plus IMTT and HI	$15.3	$15.3	$15.3	$15.3	$15.3	$15.3
Total Sum of Parts	$35.4	$38.6	$41.8	$44.9	$48.1	$51.3

We are comfortable pointing to a valuation for MIC of $45-$48 per share that will be unlocked via three deals over the next year. We think the most problematic one has already been announced. Every $90 million in taxes and fees that may need to be paid with a sale of MIC Hawaii and Atlantic is about $1/share off these totals. IMTT is expected to cost $158 million in taxes and $53 million in various fees and the $10.75/share is net of those. If the aviation side becomes a pure-play company effectively spun-off to shareholders, that may save on taxes.

National Instruments (NATI) 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 earnings quality rating of 5+ (Strong)

The company beat forecasts for adjusted EPS by 2-cents. We also see that the decline in interest rates plus borrowing money for the Optimal Plus deal was a 1.5-cent headwind y/y. The primary driver pushing down EPS has been weaker sales during COVID. We are keeping the 5+ rating as NATI is expecting sales much closer to normal levels in 4Q – rising $25-$50 million compared to 3Q. That should be worth about 9-18-cents in quarterly EPS.

While NATI borrowed money to complete its acquisition, cash and securities still exceed borrowing by $200 million. It also has $95 million on its revolver available and much of the working capital investment to grow sales may already be in place. A/R are up about 3 days but within normal ranges and Inventory levels remain at high levels, which is normal for NATI.

What improved?

- The first restructuring is essentially complete to reduce redundancies and lower headcount. It was a very small deal at about 1.5% of sales in any given year.
- Improved sales guidance to more normalized levels should leverage the lower cost structure and help EPS going forward.

What deteriorated?

- Gross margin declined about 300bp. We can account for the bulk of this due to an accounting change moving costs from SG&A to COGS, divesting AWR, and COVID. The remaining change is within historical ranges of fluctuation.
- A second restructuring was announced that is expected to be largely expensed in 4Q20 and completed within a year. We don't want to see more of these.
- Adjusted EPS is adding back several ongoing expenses such as stock compensation, amortization of capitalized R&D, and amortization of acquired intangibles which just jumped as a result of the Optimal Plus deal in July.

What to watch

- Will the Optimal Plus deal drive sales going forward and justify the price?
- An increase in tax valuation allowance of $15 million in the quarter may become a source of EPS if it declines in the future.
- The structure of the acquisition is expected to allow NATI to use the goodwill as a tax shield if income grows, it is too early to confirm that yet.
- We expect NATI to retire the debt incurred for the acquisition quickly which could limit share repurchases and allow for some share dilution.

Inventories Still Look Fine

We have talked in the past that NATI carries higher inventories as a conscious decision. The rationale is the company wants to work more on larger contracts, availability of some supplies is not always assured, inventory needs to be available worldwide, and the company wants to avoid out-of-stock situations which can cost it current and future sales. Inventory levels have held at relatively flat levels for several quarters even with COVID:

Inventory	3Q20	2Q20	1Q20	4Q19	3Q19
Raw Materials	$110.8	$112.2	$113.5	$110.1	$107.3
Work in Progress	$12.2	$10.9	$10.8	$10.6	$11.6
Finished Goods	$86.6	$86.8	$84.1	$79.7	$87.9
Total Inventory	$209.6	$209.9	$208.4	$200.4	$206.8

Sales and thus Cost of Goods dropped with COVID, which had impacts on the DSIs for inventory. The drop in Cost of Goods was about $6 million in both 1Q20 and 2Q20 as sales slowed and it accounts for about 15 DSIs, even though inventory was largely flat:

Inventory	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18
Total DSIs	216.4	228.6	231.8	204.8	224.3	231.1	251.7	206.0
Fin. Goods DSIs	89.4	94.5	93.5	81.4	95.2	104.7	114.1	91.8

Gross Margin Decline Can Be Explained

We have been impressed that NATI has essentially held flat gross margins +/- 20-30bp in most periods despite carrying so much inventory. Thus, we considered the traditional red flag of high DSIs a false positive if people are running computer screens. The margins did decline in 2020 by a noticeable amount as seen here. The adjusted margin is down about 300bp:

Gross Margin	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18
Reported	70.1%	71.5%	72.9%	75.2%	74.8%	74.9%	75.5%	75.6%
Adjusted	74.1%	74.4%	75.7%	77.6%	77.3%	77.4%	78.2%	77.9%

- $3 million per quarter in 2020 represents costs that were accounted for as SG&A previously that are now in Cost of Goods. This cut 100bp off of gross margin.

- Divesting AWR in January cost sales and margin. This cut 50-60bp off gross margin.

- COVID costs and higher logistical costs due to COVID have been 70-80bp of gross margin change.

- FX worsened and was 20-40bp of lost gross margin too

Gross Margin	3Q20	2Q20	1Q20
Adj. Year Before	77.3%	77.4%	78.2%
Adj. Current Year	74.1%	74.4%	75.7%
Difference y/y	**-3.2%**	**-3.0%**	**-2.5%**
Divesting AWR	0.6%	0.5%	0.5%
Moving $3mm from SG&A to COGS	0.9%	1.0%	1.1%
COVID/Logistics costs	0.7%	0.8%	0.3%
FX	0.2%	0.4%	0.2%
Total	**2.4%**	**2.7%**	**2.1%**

- For 3Q, the addition of Optimal Plus cost another 20bp from a change of sales mix.

In our view, adjusting for all these items – gross margin is only down 30-60bp on an apples-to-apples comparison. That minor amount of movement has been happening for years and is often due to sales growth leveraging some fixed costs more, or the reverse if sales are weaker along with changes in raw material costs. **These minor movements in margin are about 0.6-1.2 cents in EPS per quarter, based on 3Q20's sales which are still depressed.**

The company is making the trade-off of more inventory to avoid lost sales. If they lose 1% of sales at a 75% margin – it costs them about 1.4 cents per quarter. NATI continues to see stronger sales growth for orders > $20,000 than those below that figure too – that also factors into this.

The GAAP gross margin fell further in 3Q20. This is due to the increases in amortization of acquired intangible assets that began in early July 2020.

A New Acquisition but Still Conservative Accounting

As we noted in our original report, NATI is not growing through an endless series of acquisitions. It just made a $353 million acquisition in July for Optimal Plus which will support its new push into selling more software. Total assets are $1.6 billion so the deal is not a monster purchase either. Prior to that, the last major deal was in 2015 for $126 million when total assets were just under $1.5 billion. We see several positives for NATI here:

- Deals are infrequent and relatively small.

- NATI can pay for these purchases largely out of cash on hand. It currently has debt of about $89 million against $290 million in cash.

- The sale of AWR produced $160 million in cash too.

In addition, of all the companies in our universe, NATI is among the most conservative in accounting for acquisitions. Of the $353 million in purchase price, $227 million went to goodwill or 64%. That's still higher than we would prefer as it is not being amortized. However, the other $128 million assigned to intangible assets are being amortized. The amortization schedule is very similar to the asset lives assigned to internally developed assets too. **Many companies we see depreciate tech equipment over 5 years and capitalized R&D over 3-5 years. But, with an acquisition, suddenly they use 10-20 years to expense the purchased assets. That is not happening at NATI.** All the tech is being amortized over 6 years and customer relationships over 5 years. NATI's equipment and software developed/purchased for in-house use is expensed over 3-7 years.

The goodwill is expected to provide a tax shield for US taxes based on how this acquisition was structured, which could reduce costs in the future.

Restructuring Remains Conservative at NATI

NATI continues to keep the restructuring small and to the point. As they have begun moving toward more software applications, they have sought to streamline a bit. In early 2017, they announced a plan to reduce headcount by about 2%, redesign processes, eliminate job duplications and focus on higher ROI activities.

The actual size of this plan has been very small:

	3Q20	2Q20	1Q20	2019	2018	2017
Restructuring	$0.7	$1.6	$11.3	$20.1	$14.1	$17.1

While NATI adds this back as one-time items in adjusted results, this restructuring is only about 1.2-1.5% of sales in any given year. Also, the plan wrapped up and the charges became smaller.

In October after working on the integration of Optimal Plus, NATI announced another reduction in workforce plan that will cost $22-$28 million and be mostly expensed in 4Q20. We can understand that after an acquisition. We have three reasons to give NATI high marks in this area:

- The 2nd restructuring is not larger than the prior one. So many companies do a 5-year plan for $2 billion and they announce they will find $4 billion more in savings in a follow-up plan.

- Both restructurings are very small as a percentage of sales.

- Both restructurings have had modest and achievable goals – that are not based on synergies but merely some cost-cutting.

Adjusted EPS vs GAAP EPS Is a Mixed Bag

The gap between reported and adjusted EPS is widening. A large part of that is the lower sales pushing down income in recent results as other adjustments remain flat. NATI is primarily trying to add back non-cash expenses to adjusted earnings. While the company calls out some of the COVID items such as $2.2-$2.4 million in quarterly costs in the form of more expensive logistics and $8 million in quarterly savings from lower travel/entertainment spending – these are not removed from adjusted EPS.

We have a problem when a company adds back obviously recurring costs such as stock compensation. This is basically 8-9 cents of adjusted EPS every quarter. We also do not like adding back amortization of internally developed software. We're fine capitalizing the investment and amortizing it – but this cost cash to build. This is basically 3-cents per quarter of adjustments in normal sales periods.

EPS	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
GAAP EPS	-$0.04	$0.08	$1.01	$0.45	$0.39	$0.22	$0.17
Stock Comp.	$0.09	$0.09	$0.08	$0.09	$0.09	$0.07	$0.07
Amortiz Acq. Intang.	$0.05	$0.01	$0.01	$0.01	$0.01	$0.01	$0.01
Restruct/Integration	$0.09	$0.04	$0.07	$0.06	-$0.09	$0.02	$0.02
Amortiz Software	$0.04	$0.04	$0.03	$0.03	$0.03	$0.03	$0.03
Gains	$0.00	$0.00	-$0.94	-$0.08	$0.00	$0.00	$0.00
Adjusted EPS	$0.23	$0.26	$0.26	$0.56	$0.44	$0.35	$0.30

We applaud the short amortization period for acquired intangible assets. The latest deal for Optimal Plus is why the amortization per share jumped from 1-cent to 5-cents in 3Q20. However, we believe this deal consumed cash - $353 million. They are only expensing 36% of the price, which already keeps much of the cost out of the income statement as it is goodwill. We would not adjust to add back this amortization.

The restructuring charges will be larger in 4Q20. However, those adjustments should be vanishing going forward and lower operating costs with lower payroll should translate into higher EPS on a GAAP and adjusted level. If the restructuring is essentially over in 4Q, that alone should narrow the gap between reported and adjusted EPS. Also, NATI is noting that backlog and orders are growing in 4Q. The drop in sales with COVID was a big reason for lower EPS in 2Q and 3Q. Current guidance is that higher sales could translate to about 9-18 cents in higher EPS that will help both GAAP and adjusted EPS.

Further, NATI effectively has a valuation allowance against all its net deferred tax assets – the bulk of which is in Hungary. The valuation allowance jumped by $15 million from 2Q to 3Q. There is no discussion about this, but the effective tax rate in 3Q20 was -11% on GAAP earnings. The various components of foreign tax provisions are shown as huge negatives on the effective tax rate in 3Q and drove this drop. Boosting the allowance by $15 million is about 11-cents in EPS. Given the lack of discussion about it, we are not comfortable saying NATI had an 11-cent headwind for the quarter. We do think, some portion of this had a negative impact on EPS. Going forward, should NATI be able to realize some of its operating loss carryforwards, this allowance could decline and be a tailwind over time for EPS.

Air Lease (AL) 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

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We are upgrading our rating on AL to 4+ (Acceptable) indicating improvement

AL missed forecasts by 6-cents on EPS and $29 million on revenue. In both cases, a change in revenue recognition is essentially the reason. The accounting is getting more conservative in our view. The company also raised its dividend and announced its first stock repurchase and remains in compliance of debt covenants and has liquidity of $7.2 billion. The full recovery of its airline customers may still be more than a year away, but **a lack of impairment charges is a good sign that AL's portfolio remains in demand and is a valuable asset.**

What Improved?

- Deferred rent payments are being received and those payments exceed new deferrals.
- Liquidity is high as capital needs are likely to continue coming in below forecast due to delays in new plane deliveries – AL announced a $100 million stock repurchase.
- EPS missed by 6-cents in 3Q. 19-cents is due to lower gains on aircraft sales and 17-cents is due to delaying revenue recognition on certain leases until cash is collected.
- AL has not seen any impairments on the value of its fleet – the worst of COVID appears over at this point.

What deteriorated?

- Customers are still paying late. Collections vs. Collections due fell from 91% in 2Q to 86% in 3Q.
- Both GAAP and Adjusted EPS include some one-time items such as canceled security deposits adding 4-cents in 1Q and buying notes back at a discount for 10-cents in 2Q.
- By not adjusting for gains on asset sales – adjusted EPS is now suffering because there are simply fewer asset sales and lower gains. This was a 19-cent hit to EPS in 3Q.

What to watch

- **AL is meeting debt covenants at essentially the levels seen pre-COVID.**
    - Equity must be > $2b – it is $6.0b and has risen this year.
    - Total Debt/Equity must be less than 3x and is at 2.3x.
    - Aircraft/unsecured debt > 125% - it is 140%
    - BBB- or greater debt rating. It is BBB, but is on negative watch

- Will more airlines restructure balance sheets that create additional delays in AL being paid?

Air Lease Changed Revenue Recognition on Some Leases to a Cash-Received Basis

AL has long-term leases on its planes with customers and it books revenue based on scheduled lease payments being due. With COVID – many of its airline customers have grounded planes and reduced service. The book is 73% leased to flag carriers of various countries where the government has an ownership stake in the airline. Those and others are receiving government financing deals as part of various COVID plans.

58% of its customers have received some sort of payment deferral plan from AL. Typically, these were 3-month deferrals that are now being repaid. **So far $60 million of the $201 million in deferred payment have been repaid, which is 30% of the total given. Repayments of deferred leases exceed the amount of current requests for deferrals. We consider this a sign of improvement for AL's business.** Also, customers who are working to cut costs are frequently culling older planes which burn more fuel and require more maintenance. That makes AL's planes highly desirable and customers want to keep them as they are new and more efficient.

At the same time, AL has to review the credit quality of its customers and assess how likely timely lease payments are. That can also include customers who are restructuring and want to keep the planes but may need to complete their restructuring before making payments for past rent. In that situation, collection of rent is not assured. In the 3Q, AL identified $25.3 million of lease payments that fit this situation. It is accounting for those leases as cash is received at this point. This is a change to a more conservative method of revenue recognition that takes these delays into account.

This $25.3 million in lease payments that were not recognized cost AL 17-cents in EPS and was the entire reason for the earnings miss. It also impacted the $29 million revenue miss.

While it appears the worst of COVID issues are ending with deferrals being repaid and we think AL has planes in high demand, AL still has airlines that are likely to do some significant restructuring before this is over. It currently has 19 planes with 5 airlines in this process already. It seems likely that more of this would be a pre-packaged type of bankruptcy where the negotiations happen out of court and the legal process is more of issue of giving it final approval. Thus, there could be more leases that require cash collection to recognize revenue before this is over. That may continue to pressure revenue in the coming quarters.

Cash Flow from Operations is down $254 million through 9-months of 2020 so far. We know much of this is due to these reasons. Deferred rent not yet collected is $141.7 million and the leases converted to **cash collection status for revenue recognition is $25.3 million**. That leaves an $87.0 million difference. **Accrued interest and payables are down $84.0 million** and rent received in advance is $3.4 million.

AL is still getting paid late. The collection rate was basically 90% in 1Q and 2Q and 86% in 3Q. This is defined as the amount of cash collected vs. the amount of receivables due. It adjusts for deferred rent and the change in revenue recognition in 3Q to lower the amounts due.

The Lack of Gains Impacted Earnings and Revenue Too

One area where we thought AL's adjusted EPS was aggressive is it adds back recurring items such as stock option expense and amortization of deferred debt issuance costs – but doesn't exclude gains on asset sales. Given that AL pays people with stock, continually finances new planes, and also is an active trader of planes – we would consider all of these to be recurring items and core parts of the results.

Where AL is suffering on results now is the volume of aircraft sales is down considerably. Thus, it is not booking the same level of gains or income from aircraft trading. Here are the trends for 2020:

	3Q20	2Q20	1Q20
Gains on Aircraft	$2.6	$4.9	$1.6
Gain on M-T Note	$0.0	$13.6	$0.0
Forfeited Deposits	$0.0	$0.0	$5.9
Per share	$2.6	$18.5	$7.5

Historically, gains on aircraft sales are about $30-$50 million for AL. This year there just are not many transactions as AL warned about in the 1Q20 10-Q:

> *"COVID-19 has disrupted some of our operations. While our employees are working remotely, due to travel restrictions and business limitations and shutdowns, **some transitions of our aircraft from one lessee to another lessee have been delayed. Some planned aircraft sales have been delayed or terminated** as a result of business limitations and shutdowns. We expect these disruptions to continue and they could worsen. We also expect that demand for used aircraft will decline in the near-term and that we will sell fewer used aircraft in 2020 and perhaps 2021 than we initially planned to sell."*

At the same time, it really did have some one-time events hit this year. In 1Q, customers backed out of deals and forfeiting deposits which were added into trading revenue. In 2Q, AL repurchased some medium-term notes at a discount and recognized a $13.6 million gain. Both of those were left in GAAP EPS and Adjusted EPS. For 1Q20 – the deposits added 4-cents to GAAP and Adjusted EPS. For 2Q20 – the gain on repurchasing notes at a discount added 10-cents to both EPS figures.

In 3Q20, there was only one plane sold. Gains of $2.6 million were down y/y from $30.2 million. That drop is 19-cents in EPS y/y for 3Q. That more than counts for the earnings miss in the quarter too.

We think the accounting at AL is fairly strong, except in this one area. If they continually add back recurring lumpy costs, they probably should be subtracting recurring lumpy gains from adjusted EPS. Because they don't do that way, they are getting hit on GAAP and Adjusted EPS when the gains disappear.

Liquidity Looks Solid

AL still has $7.2 billion in liquidity – cash on hand plus credit lines. The capital spending is likely to be lighter than expected because the Boeing 737-Max is not being produced now and the Airbus A320-neos have also had production delays. For the rest of 2020, AL has 14 planes scheduled for delivery but 7 are A320-neos. For 2021, AL has 63 planes scheduled for delivery, but 15 are Max and 32 are Neos. In 2020, they are expecting to have $2.5 billion in new planes vs. $6 billion that was originally forecast. Thus, they are carrying excess cash and liquidity.

Debt maturities are also not very heavy at $173 million for the rest of 2020 and $1.9 billion for 2021. The company's planes are in high demand because they are cheaper to operate due to lower fuel usage and newer making maintenance less costly too. Airlines looking to permanently lower costs are likely to retire more older planes at this time and with delays on getting newer planes – we doubt AL will have little difficulty rolling over debt or selling planes if necessary.

The company authorized its first stock repurchase of $100 million. That is enough to purchase about 2.5% of the stock. It also raised the dividend. From 15-cents to 16-cents.

Sysco (SYY) 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 maintain our earnings quality rating of 3- (Minor Concern)

SYY reported adjusted EPS of $0.34 which was 7 cps ahead of consensus estimates. The company has fought through COVID's impact on its customers by expanding to new areas of distribution such as supermarkets and helping its customer base work through their problems. Its market-dominating size has been a plus in this regard. We have criticized SYY's quarterly results several times over the years due to multiple unusual items amounting to a few cents here and there that seemed to allow the company to barely meet or slightly beat earnings estimates. The dramatic decline in EPS during the COVID quarters has more than overshadowed the relevance of those types of items. As conditions begin to normalize, they will begin to stand out more. We will revisit some of our longer-term concerns with the company in this update.

What deteriorated?

- SYY has been in perpetual restructuring mode since the 2016 acquisition of Brakes. Restructuring and transformational charges have grown larger almost every year, amounting to $371 million in the year ended 6/20. Such amounts are added back to non-GAAP earnings and essentially dismissed by analysts focusing only on the non-GAAP numbers. Some of the recent charges appear to relate to the company's acceleration to improve its technological capabilities, but we question if all these amounts should be considered non-operational. Also, some charges are attributed to ongoing integration issues in the company's French and UK operations. Regardless of the location of the spending, the bulk of the charges are described as severance

charges, facility closures, integration charges, and changes in technology, most of which should result in cash expenditures. Such a large amount of cash charges being dismissed over so many years in our view reduces the quality of the non-GAAP earnings.
(Concern level: MEDIUM)

- The company also adds back the amortization of intangibles associated with the Brakes acquisition to non-GAAP earnings. To the company's credit, it does not add back amortization from its smaller acquisitions done over the years. Just the amortization of Brakes typically amounts to 2-3% of non-GAAP operating income. Also, the company took $203 million in goodwill impairments in the June quarter with $109 million of that attributed to the France group which was picked up in the Brakes deal. So, from the perspective of non-GAAP earnings, the cost of amortization for the Brakes deal, the sizeable restructuring and integration charges associated with it, and the write-down of the goodwill all never cost shareholders a penny.
(Concern level: MEDIUM)

- A lower than expected tax rate added about a penny to EPS.
(Concern level: LOW)

What improved?

- SYY identified $170 million and $154 million in incremental provision for bad debt expense related to COVID in the 6/20 and 3/20 quarters, respectively which it added back to non-GAAP results. In the 9/20 quarter, the company experienced significant improvement in the collection of receivables which resulted in a positive adjustment to bad debt provision of $99 million. To the company's credit, the benefit was adjusted out of its non-GAAP results for the 9/20 quarter.

What to watch

- Management stated in the conference call that it does not anticipate making any share repurchases for the remainder of FY 2021. Previously, the lower share count was boosting EPS growth by approximately 1.5%-2% per quarter and this tailwind will begin to wane going forward.

Restructuring Charges Continue

(Concern level: MEDIUM)

SYY has been in perpetual restructuring mode for years in the wake of its 2016 acquisition of Cucina Lux Investments, the holding company of the Brakes Group. Brakes is a European foodservice business distributing products to restaurants and pubs in primarily the UK, France, Ireland, and Sweden. The following table shows restructuring and transformational charges which the company added back to non-GAAP operating profit for the last five fiscal years:

FY Ended June:	2020	2019	2018	2017	2016
Non-GAAP Operating Income	$1,711.995	$2,733.282	$2,533.416	$2,351.831	$2,009.248
Restructuring & Transformational Charges	$371.088	$325.300	$109.524	$161.011	$123.134

Before 2016, the company recorded nominal severance and facility closure charges. However, the Brakes acquisition has posed several challenges, resulting in a steady increase in the expenses incurred. Consider the following description of the 2020 charges in the 6/20 10-K:

> *"[Operating expenses included] our ongoing restructuring and integration work in our European operations and facility consolidations in our Canadian operations.* ***Our business in France continued to experience operational challenges arising from our integration efforts. Restructuring and business transformation charges also negatively affected our U.K. operations as we continue our efforts related to modernizing the business and growing our customer base."***

In addition, the company has undergone various "transformation programs" with the latest focused on regionalization, accelerating the adoption of Sysco Shop digital ordering, and equipping the salesforce with new tools. Management identified $350 million in expenses that will be eliminated from the cost structure in FY 2021. However, some of these amounts, particularly the ones involving investment in technology upgrades, sound as if they are simply operational investments in the business and should not be viewed as non-operational in nature.

Also, the fact remains that analysts are being asked to add an ever-increasing stream of "one-time" charges back to earnings and the bulk of these charges appear to be cash.

Consider the description in the 10-K of the 2020 and 2019 restructuring and transformational charges:

> *"Fiscal 2020 includes $265 million related to restructuring, severance and facility closure charges, of which $99 million relates to severance charges. Fiscal 2020 also includes $106 million related to various transformation initiative costs, primarily consisting of changes to our business technology strategy. Fiscal 2019 includes $174 million related to severance, restructuring and facility closure charges in Europe and Canada and at Corporate, of which $61 million relates to our France restructuring (i.e. our integration of Brake France and Davigel into Sysco France), and $151 million related to various transformation initiatives costs, of which $18 million relates to accelerated depreciation with regard to software that was replaced."*

The majority of the charges are described as severance charges, facility closures, integration charges, and changes in technology. Only $18 million was called out as accelerated depreciation which would be a non-cash charge. Such a large amount of cash charges over so many years in our view reduces the quality of the non-GAAP earnings numbers.

Adding Back Acquisition Costs- Namely Amortization

(Concern level: MEDIUM)

In addition to adding back restructuring and integration charges related to acquisitions, SYY also adds back "acquisition-related costs" which is essentially the amortization of the intangibles picked up in the Brakes deal. To the company's credit, it does not add back amortization from intangibles picked up in other smaller deals it has done over the years. The following table shows acquisition-related costs added back for the last five fiscal years ended June:

FY Ended	2020	2019	2018	2017	2016
Non-GAAP Operating Income	$1,711.995	$2,733.282	$2,533.416	$2,351.831	$2,009.248
Acquisition-Related Costs	$64.793	$77.832	$108.136	$102.049	$35.614

While we applaud not adding back costs from smaller acquisitions, we nonetheless disagree with the principle of ignoring the cost of the acquisition. Also, we note that the company incurred $203 million in goodwill impairments in fiscal 2020 with $109 million of that related to the France Group which was picked up in the Brakes deal. Of course, the impairment charge was also added back to the non-GAAP results. So, from the perspective of non-GAAP earnings, the cost of amortization for the Brakes deal, the sizeable restructuring and integration charges associated with it, and the write-down of the goodwill all never cost shareholders a penny.

Lower Tax Rate Added a Penny

(Concern level: LOW)

The adjusted effective tax rate was 19.7% in the 9/20 quarter versus 22.2% in the year-ago quarter. Management noted that it was below normal due to "favorable impacts of equity compensation and other factors." This added only about a penny per share to EPS in a quarter where the company beat by 7 cps which warrants a low concern level.

The Previous Boost to Allowances Reversed- But SYY Adjusted the Benefit Out

SYY was understandably experiencing collection issues with its receivables at the onset of COVID as its restaurant customers were struggling to generate cash flow. This resulted in the company identifying $170 million and $154 million in incremental provision for bad debt expense in the 6/20 and 3/20 quarters, respectively. SYY added these amounts back to its non-GAAP results. In the 9/20 quarter, the company experienced significant improvement in the collection of receivables which resulted in an adjustment to bad debt provision of $99 million. To the company's credit, the benefit was adjusted out of its non-GAAP results for the 9/20 quarter.

Zimmer Biomet (ZBH) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	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 upgrading our earnings quality rating to 3+ (Minor Concern)

ZBH's adjusted EPS of $1.81 in the 9/20 quarter sailed past the consensus EPS targets by 73 cps. We are raising our earnings quality rating mostly on the improvement in the receivables situation although we are still cautious of the company's long list of non-GAAP add-backs.

What improved?

- While days of sales for receivables left on the balance sheet increased YOY from 55.9 to 63.9, days of sales based on receivables that have been sold but remain outstanding at the end of the period fell dramatically, causing the total adjusted receivables DSOs to decline from 74.1 to 68.1. We view this as a positive for the quality of earnings in the period. However, the massive decline in factoring resulted in a drain on cash flow growth with the company quantifying the impact at $230 million for the first nine months of the year.

What to watch

- ZBH announced its 2019 Restructuring Plan at the end of 2019. It is expected to cost $350-$400 million through 2023 and result in $200-$300 million in annual cost savings by then. It incurred $89 million in costs in the first nine months of 2020 which it added back to non-GAAP results. Our concern level will increase with any expansion of the size or scope of the plan or the addition of any new plans. We note that the company already took over $2 billion in merger-related and restructuring charges in the two years following the $14 billion Biomet deal.

- In addition to restructuring charges, the company regularly adds back items such as obsolete inventory and manufacturing-related charges on product lines it plans to discontinue, ongoing quality remediation charges, litigation charges as well as an "other" category which includes a hodge-podge of charges including "legal entity, distribution and manufacturing optimization, and costs to comply with its DPA agreement with the government. Some of these amounts may be reasonable to add back but other categories seem broad and potentially operational in nature.

- Like most companies, ZBH temporarily reduced spending on discretionary items including travel and unnecessary items. The impact on R&D was particularly noticeable with adjusted R&D declining to $83.9 million in the 9/20 quarter from $103 million in the year-ago period. Just that amount represents about 7 cps which will inevitably have to reverse over the next couple of quarters.

Receivables Securitization Declined

ZBH maintains a receivables factoring program by which it sells customer receivables to third-party financing institutions to accelerate the receipt of cash. We have previously pointed out that the use of the factoring program was rapidly increasing and masking an overall increase in the level of receivables as well as temporarily boosting cash flow growth. This situation has now reversed, as seen in the following table:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Trade Receivables	$1,340.7	$1,064.5	$1,039.1	$1,363.9
Outstanding Principal Amount Derecognized for US and Japan	$87.0	$220.3	$421.8	$270.2
Receivables Adjusted for US and Japan Factoring	$1,427.7	$1,284.8	$1,460.9	$1,634.1
Trade Receivables Days of Sales	63.9	79.0	53.0	59.0
Factored Receivables Days of Sales	4.1	16.4	21.5	11.7
DSOs Adjusted for US and Japan Factoring	68.1	95.4	74.5	70.7

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Trade Receivables	$1,150.8	$1,247.1	$1,225.3	$1,275.8
Outstanding Principal Amount Derecognized for US and Japan	$372.6	$378.1	$390.4	$365.9
Receivables Adjusted for US and Japan Factoring	$1,523.4	$1,625.2	$1,615.7	$1,641.7
Trade Receivables Days of Sales	55.9	57.1	55.8	56.7
Factored Receivables Days of Sales	18.1	17.3	17.8	16.3
DSOs Adjusted for US and Japan Factoring	74.1	74.4	73.6	72.9

While days of sales for receivables left on the balance sheet increased YOY from 55.9 to 63.9, days of sales based on receivables that have been sold but remain outstanding at the end of the period fell dramatically, causing the total adjusted receivables DSOs to decline from 74.1 to 68.1. We view this as a positive for the quality of earnings in the period. However, the massive decline in factoring resulted in a drain on cash flow growth with the company quantifying the impact at $230 million for the first nine months of the year.

We also note that the outstanding principal amount of receivables sold and still outstanding include US and Japan receivables but not European receivables. In a previous review, we noted that language in the company's 10-Q made us wonder if the figure for total receivables sold to third parties also did not include receivables sold in Europe. For clarification and future reference, the company has confirmed that it does.

Restructuring and Cost Reduction Initiatives

ZBH announced a restructuring program at the beginning of 2019 to reduce operating costs. The "2019 Restructuring Plan" is expected to result in $350-400 million in spending through 2023 with the hopes of generating $200-$300 million in annual cost savings by then. The charge is expected to consist of "employee termination benefits; contract terminations for facilities and sales agents; and other charges, such as consulting fees, project management and relocation costs." In the first nine months of 2019, pretax charges have amounted to $89 million or approximately 9% of non-GAAP operating income. If the program stays on track in terms of scope and time frame, we will not be overly concerned. However, we remind investors that ZBH took enormous restructuring charges after the

2015 acquisition of Biomet. Between 2015 and 2017, ZBH recorded "Biomet Merger-Related Charges of $1.4 billion-plus another $730 million in "Other Special Items." The company discussed the "Other Special Items" in its 2017 10-K as follows:

> *"We recognize expenses resulting directly from our business combinations, employee termination benefits, certain R&D agreements, certain contract terminations, consulting and professional fees and asset impairment or loss on disposal charges connected with global restructuring, quality and operational excellence initiatives, and other items as "Special items" in our consolidated statements of earnings. We recognized significant expenses in 2015 due to Biomet merger-related expenses, such as the acceleration of unvested LVB stock options and LVB stock-based awards, retention bonuses paid to Biomet employees and third-party sales agents who remained with Biomet through the Closing Date, severance expense and contract terminations. Expenses declined in 2016 due to the absence of certain of these expenses. In 2017, Biomet-related integration expenses continued to decline, but we have incurred additional costs related to quality remediation at our Warsaw North Campus facility."*

Unusual expenses related to an acquisition as large as the $14 billion Biomet deal are understandable. Regardless, our concern will increase if the size and scope of the 2019 plan begin to increase or new plans are announced.

Clorox (CLX) 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).

CLX reported non-GAAP EPS of $3.22 in the 9/20 quarter which was 97 cps ahead of estimates. We did not see any significant earning quality issues in the quarter. Unlike most companies, CLX does not regularly report non-GAAP earnings figures with an endless array of one-time charges added back. In most quarters, the EPS figure at the bottom of the income statement is what is compared to the consensus target which we find refreshing. This quarter did contain a non-operating gain of about 52 cps, but the earnings beat was well intact after adjustment for that.

We also remind clients that our earnings quality review score reflects the reliability of the reported earnings and cash flows and does not take fundamental macro and market demand factors into consideration. Virtually all of CLX's products are receiving a huge boost from COVID- cleaning products, kitty litter, trash bags, and grilling products. When the COVID impact laps, the organic growth rate will fall from its current near-30% rate, and when conditions return to normal, organic YOY declines are quite likely. When that happens and how far the decline will be are questions beyond the scope of this report.

What deteriorated?

- During the quarter, CLX increased its investment in its joint venture in Saudi Arabia from 30% to 51% resulting in the company consolidating the operations on its financial statements. This resulted in a remeasurement of its existing ownership which generated a one-time non-cash gain of $85 million or about 52 cps. This accounts for just over half of the 97 cps earnings beat in the quarter, so we consider this a non-issue for earnings quality.

What to watch

- We have identified several companies with a large presence in Latin American that are receiving an artificial boost in their organic sales growth figures which have the negative impact of FX rates adjusted out but continue to benefit from unsustainable, inflation-driven price increase in those markets. We have noted in the past that CLX has received a meaningful benefit from this phenomenon in the past. International organic sales did receive a benefit in the quarter from 8% pricing growth while the 8% negative FX impact was adjusted out. This did artificially boost total company organic sales growth by about a point and a half, but with COVID driving 27% organic growth, the impact is less meaningful now.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

Disclosure

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