BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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International Business Machines Corp. (IBM) EQ Review- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	na

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

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

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

We are initiating earnings quality coverage with a 2- (Weak) rating.

IBM recently announced it would spin-off some of its older technology units and focus on the remaining "growth" units. Our problem is IBM has been doing this for 20 years now – not with a full spin-off but culling lower margin units and making 172 acquisitions of new growth companies. Coming into the spin-off, IBM has almost tripled its debt and despite all the deals, it is posting nearly the same income as it was 15-years ago.

IBM hit forecasts in 3Q20 and beat slightly in 2Q and 1Q. We believe the company has benefited from cutting advertising, R&D, and depreciation to achieve its earnings goals.

Adjusted earnings are inflated as it ignores all acquisition-related amortization and both adjusted and GAAP earnings are inflated by assigning the bulk of acquisitions to goodwill which is not being expensed at all. With $2.5 billion in new restructuring charges expected in 2021, we expect earnings quality to get worse.

What concerns us?

- IBM is earning about the same profit now as in 2005 – about $12 billion. That is being helped by nearly $1 billion by using longer amortization lives for Red Hat than prior deals.
- After buying over 100 software companies in the last 15-17 years, IBM has seen R&D spending decline and invested less in software on the cash flow statement.
- Goodwill is now 350% of equity and debt has almost tripled to fund acquisitions. Non-expensing of goodwill is also boosting income.
- Adjusted earnings add back several recurring charges related to pensions and acquisitions.
- ROI appears lower than when all this portfolio turnover began. That's before adjusting for lack of expensing for acquired assets or using longer life assumptions.

What is strong?

- IBM has over $14 billion in cash on hand so we do not see the dividend or debt facing near-term problems.
- The company has reduced its financing services and has picked up cash flow from selling and collecting receivables – this has produced about $17 billion since 2018.

What to watch

- The cash from receivables may dry up going forward and IBM would have a difficult time funding share repurchases without it in our view. Lack of share repurchases has already become a headwind for EPS growth in 2020 vs. a historical 3% tailwind.

- IBM has taken about $11 billion in charges to right-size its workforce since 2003. It leaves these in adjusted EPS. With the spin-off and $2.5 billion in charges – will these workforce charges find their way into adjustments in 2021 and create higher EPS growth?

- IBM realized a $939 tax benefit from an intra-company transfer or intangible assets in 1Q20. Will a spin-off result in more of these types of one-time benefits in 2021?

- Capital spending recently turned up after seeing it decline for several years. Will this become a new trend and result in lower free cash flow? Will this cause depreciation to be a drag on margins?

Big Picture – IBM Over Time

This company has been around for a long time. It has changed its products and services multiple times. Since 2003, IBM has made 172 acquisitions – largely in software – and spent over $11 billion cutting workforce – about $500 million per year. All of that is with the goal of boosting revenue growth and profitability.

Just looking through the annual reports investors will see continual references to:

- IBM is reinventing itself
- IBM has culled out lower-margin businesses
- IBM will pursue high-value innovation over commodity technology via acquisitions

We think a snapshot of what IBM was doing in 2003-05 (non-recession years) compared to 2017-19 (recent non-recession years) may be enlightening:

	2019	2018	2017	2005	2004	2003
Sales	$77,147	$79,591	$79,139	$91,134	$96,293	$89,131
Gross Profit	$36,488	$36,936	$36,943	$36,532	$35,569	$32,547
EBIT	$11,232	$12,663	$12,214	$12,561	$11,205	$10,016
Gross Margin	47.3%	46.4%	46.7%	40.1%	36.9%	36.5%
EBIT Margin	14.6%	15.9%	15.4%	13.8%	11.6%	11.2%
Debt	$62,899	$45,812	$46,824	$22,641	$22,927	$23,632
Equity	$20,985	$16,929	$17,725	$33,098	$31,688	$27,864
ROI	13.4%	20.2%	18.9%	22.5%	20.5%	19.5%

This table makes very modest adjustments. It shows GAAP revenue and gross profit. Getting to EBIT, we added back interest expense, added back restructuring costs and charges for workforce reductions, and removed gains on asset sales. Just looking at that, it appears IBM is making basically the same profit now as it did 15 years ago on lower sales. In 2019, Red Hat results only reflect partial year results in 2019 against the full amount of debt which is why the ROI fell in 2019. In 2005, selling the low margin PC business to Lenovo was a big part of the margin gain.

In addition to negative top-line growth, what jumps out at us is IBM has clearly elevated its debt levels as it acquired more companies over the years rather than build in-house. That also means IBM never expensed much of the purchase price as it held a rising goodwill figure on the balance sheet. Looking over time, it appears that IBM viewed items like capital spending and R&D as places to save money. For a company that bought many software companies, it is spending less on new software development now than 15-years ago.

	2019	2018	2017	2005	2004	2003
Capital Exp.	$2,286	$3,395	$3,229	$3,842	$4,368	$4,393
Software Dev.	$621	$569	$544	$792	$688	$581
R&D Spend	$5,989	$5,379	$5,590	$5,842	$5,874	$5,314
Acquisitions	$32,630	$139	$496	$1,482	$1,738	$1,836
Goodwill	$58,222	$36,265	$36,788	$9,441	$8,437	$6,921
Acq. Intangibles	$15,235	$3,087	$3,742	$1,663	$1,789	$1,724
Equity	$20,985	$16,929	$17,725	$33,098	$31,688	$27,864

Goodwill and intangibles have gone from less than one-third of equity to 350% of equity. It's not expensing the goodwill at all. That is where IBM picked up about 1-2 points in EBIT margin and ROI. Also, the acquired intangibles were amortized over 3-7 years in 2005. Now, amortization is as long as 20 years. That is helping margins too. For non-GAAP results, IBM adds back all the amortization of acquired intangibles arguing those are non-cash expenses. Go tell the people who loaned IBM $58 billion that the acquisitions didn't use cash. Until 2019, IBM was also picking up margin from having lower depreciation.

With this big picture in mind, and IBM having announced it will split into two companies next year, we decided to look more closely at IBM's accounting methods and earnings quality.

Recent GAAP vs. Non-GAAP Show EPS Is Inflated by Ignoring Recurring Costs

In the last eight quarters, IBM has routinely reported adjusted Non-GAAP EPS about 40% higher than GAAP.

IBM's EPS	3Q20	2Q20	1Q20	4Q19
GAAP EPS	$1.89	$1.52	$1.31	$4.11
Add Acq. Exp.	$0.40	$0.41	$0.42	$0.42
Add Retirement Chgs	$0.26	$0.25	$0.28	$0.20
Add Tax Issues	$0.03	$0.00	-$0.17	-$0.02
Non-GAAP EPS	$2.58	$2.18	$1.84	$4.71
Non-GAAP Inflation	36.5%	43.4%	40.5%	14.6%
	3Q19	2Q19	1Q19	4Q18
GAAP EPS	$1.87	$2.81	$1.78	$2.15
Add Acq. Exp.	$0.66	$0.24	$0.18	$0.19
Add Retirement Chgs	$0.14	$0.11	$0.13	$0.38
Add Tax Issues	$0.01	$0.01	$0.16	$2.15
Non-GAAP EPS	$2.68	$3.17	$2.25	$4.87
Non-GAAP Inflation	43.3%	12.8%	26.4%	126.5%

We are willing to live with the tax issues that are largely immaterial. The 4Q18 tax adjustment relates to the tax law changes that every company had to deal with.

The 1Q20 tax issue was the result of transferring intangible assets to a different IBM entity. That led to setting up a deferred tax asset of $3.4 billion and a one-time benefit on income taxes of $939 million. To IBM's credit, it adjusted this benefit out of non-GAAP earnings. **We will be skeptical if we see several more of these types of tax benefits from transfers taken during the spin-off process during 2021** – especially if the company announces that its $2.5 billion cost forecast for the spinoff came in lighter due to moving other intangible assets to create one-time income from taxes.

The non-operating retirement adjustments are certainly a recurring charge. IBM defines these as "*Non-operating retirement-related costs are primarily related to* ***changes in pension plan assets and liabilities which are tied to financial market performance****, and the company considers these costs to be outside of the operational performance of the business*." Much of these represent the recognition of actuarial losses. These adjustments can also include "*defined benefit plan and nonpension postretirement benefit plan amortization of prior service costs, interest cost, expected return on plan assets, amortized actuarial gains/losses, the* ***impacts of any plan curtailments/settlements*** *and pension insolvency costs and other costs*." We think that given much of the continual workforce realignments, pension settlements may also be a part of this adjustment.

These changes can impact pension funding levels and result in additional cash infusions to the pension plans. IBM specifically calls this out as an issue for foreign pensions, "**Financial market performance could increase the legally mandated minimum contributions in certain non-U.S. countries that require more frequent remeasurement of the funded status.** We are not quantifying any further impact from pension funding because it is not possible to predict future movements in the capital markets or pension plan funding regulations."

The jump in recent acquisition expenses being added back are primarily the amortization of intangible assets and transaction costs for Red Hat. We are going to say that we consider these cash expenses as IBM pays cash for all these intangible assets. We are also going to say that these are recurring expenses as IBM made 172 acquisitions between 2003-2020. There are periods when the transaction costs and integration are at higher levels, but those

represent cash payments also, just like realigning workforce levels and real estate are. Here are the recent pre-tax charges that IBM is adding back:

Acquisition Adjustments	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18
Amort. Intang.	$458	$472	$473	$482	$473	$169	$173	$195
Transactions	$0	$0	$0	$26	$254	$102	$39	$12

We believe the recurring amortization of intangibles is impacted by IBM changing the amortization assumptions. Here are some assumptions in past years:

Amort Lives in Yrs	Red Hat	2017	2015	2013	2011
Client Relations	10	5-7	5-7	6-7	7
Completed Tech	9	5	5-7	5-7	7
Trademark/Patents	20	1-5	2-7	2-7	1-7

With Red Hat, IBM added $13.5 billion in intangible assets that are being expensed. It also assumed they had longer lives than most of the other deals they have made.

- Red Hat Client Relationships were valued at $7.2 billion and are creating a $720 million annual expense. However, at 7-years, the amortization would be $1.03 billion per year. EPS would be $0.27 lower per year.

- Red Hat Completed Technology was valued at $4.6 billion created at $511 million annual expense. At a more consistent 5-year policy, it would be $920 million in expense. That would cut EPS by $0.36 per year.

- Red Hat Trademarks and Patents were valued at $1.7 billion and are only being expensed $85 million per year. Past assumptions would indicate, 5-years may be more reasonable. That would cut EPS by $0.22 per year.

Remember the first table comparing IBM's recent results to 2005-2003 where EBIT is essentially flat at $12 billion. Simply giving Red Hat much longer amortization lives on intangible assets is adding almost $1 billion to EBIT. Using more consistent amortization lives makes current results look considerably less attractive.

Also, they still assigned the bulk of acquisition costs to Goodwill. IBM has $58 billion in Goodwill with $23 billion from Red Hat (Red Hat cost $35 billion so 66% of the purchase price is not being amortized at all.) Had IBM built any of these assets assigned as goodwill in-house, margins would be considerably lower. This is supposed to be tech company – are there any assets here with eternal life? Think of the personal computer – it essentially didn't exist 40 years ago. It came out and grew and IBM divested it for a modest sum 15-years ago. There was a solid 10-12 years where that was a big part of the business, but that is a far cry from saying its value today should still be carried on the books as goodwill forever.

Given IBM's goodwill a 40-year life and expensing it – it would cut another $1.5 billion off of EBIT. That would make EBIT in the $9.5-$10.0 billion range and ROI would be about 11%-12% and EBIT margins would about 12%-13% - roughly equal to 2004-2005. That may still be overly generous. Had they built these assets in-house a 10-15 year life may be more reasonable and that would cut the returns even more.

That's why we say these are real expenses. IBM is spending real cash and incurring real debt to pay for these assets. Lengthening amortization lives and then calling the amortization a non-recurring cost is inflating income figures. Plus, assigning the bulk of the purchase price to goodwill and not amortizing it all is inflating income even more. The goodwill argument is always that *Mickey Mouse* and *Oreos* represent iconic assets that have demonstrated proven value for much longer than 40 years. We counter that we have seen far more assets like VCRs or 35mm film where new technology made the older assets obsolete quicker than most people expected. What we would expect is IBM to see a growing risk of impairments for intangible assets including goodwill – or investors will see it cull assets it acquired 5-10 years ago at lower prices as tech changes further. We will be curious to see if the spin-off in 2021 results in some impairments of intangible assets that are moved to the spin-off entity. Of the $2.5 billion in charges expected with the spin-off, $1.0 billion are expected to be non-cash.

Recent EPS Was Helped by Reduced Costs

Most people are going to give passes for 2020 results. IBM also has issues with Red Hat being a significant acquisition during 2019 that can skew y/y results. Red Hat was

spending about $600 million on R&D per year or $150 million per quarter. It was spending about $30 million per quarter on advertising as well. We were looking for quarters where spending was up for the combined company by at least that much:

3Q20 saw reported EPS of $1.89 and IBM met forecasts:

- R&D declined by $38 million – which added 3-cents to EPS.
- If R&D should have risen – the EPS would have had a negative impact.
- Advertising declined by $20 million – which added 2-cents to EPS.
- Same as R&D, it probably should have increased and thus the EPS would have dropped.
- Workforce expenses fell by $6 million – which added another 0.5 cents.

2Q20 saw reported EPS of $1.52 and IBM beat forecasts by 9-cents:

- Advertising fell by $58 million – which added 5-cents to EPS.
- Workforce expenses fell by $358 million – which added 32-cents to EPS.
- R&D rose by $175 million which looks fine or even a 2-cent headwind.

1Q20 saw reported EPS of $1.31, which beat by 4-cents adjusted for the tax benefit of $0.17 from transferring intangibles to another intra-company entity:

- Advertising fell by $4 million – adding 0.4 cents to EPS, and probably helped by 3-cents as advertising should have risen by $30 million.
- Depreciation fell by $131 million. Red Hat should have added about $15 million. That likely added by another 12-cents.
- R&D looked fine as it rose nearly $200 million y/y.
- Workforce reductions also jumped over $700 million y/y.

While not directly impacting immediate EPS, we did notice that investing in software remained flat at IBM after the Red Hat deal. Also, capital spending remained flat until 3Q20 when it did increase.

Also, as we noted earlier, IBM has taken a charge to cut its workforce every year for over 18 years now. In both GAAP and non-GAAP EPS, the company does not adjust for that. We will be curious to see with the spin-off where it expects $2.5 billion in charges – if

workforce reductions become part of that $2.5 billion and are added back going forward. That would set up apples-to-oranges EPS comps where 2021 has the charges added back while 2020 did not.

Cashflow Has Been Helped by Winding down Financing and Selling Receivables

If we look at the basic parts of cash flow from operations being income plus non-cash items like depreciation and amortization against cash needs like capital spending, dividends, and share repurchases – IBM has not had much wiggle-room of late:

Cash Flow	2020 ytd	2019	2018	2017
Net Income	$4,234	$9,431	$8,728	$5,753
Non/Cash Items	$5,734	$4,115	$5,996	$4,158
Cash In	$9,968	$13,546	$14,724	$9,911
Capital Spend	$1,940	$2,286	$3,395	$3,229
Software Spend	$469	$621	$569	$544
Free Cash Flow	$7,559	$10,639	$10,760	$6,138
Dividends	$4,343	$5,707	$5,666	$5,506
Share Repos	$0	$1,361	$4,443	$4,340

We have already highlighted that IBM has been spending less on R&D and advertising recently to help income and cash flow. It has been spending less on capital expenditures and software too. The business has had a tough time covering dividends and share repurchases in recent years at prior levels. And we know they have spent money on acquisitions.

What is less obvious is they have pulled a sizeable amount of cash out of the various receivables. IBM has stopped doing commercial financing for OEM IT distributors.

- In 2018, total receivables fell by $1.5 billion from $41.2 million.
- In 2019, they dropped $7.2 billion more.
- So far in 2020, they are down by $8.2 billion. IBM has even accelerated that further by selling receivables and picked up $1.6 billion of the $8.2 billion in 2020 with that method.

So this is cash coming in to cover acquisitions and other spending. It's not going to hit zero. And it's already down nearly $17 billion. This source of cash flow may have less of an impact going forward and leave IBM to deal with a cash flow statement that looks more like the table above which does not show working capital benefits.

The fact that share repurchases slowed considerably in 2019 and stopped in 2020 is starting to show up in reduced EPS growth:

EPS Growth	3Q20	2019	2018	2017
y/y Income growth	1.5%	8.4%	51.5%	-51.5%
EPS growth	1.0%	11.1%	54.9%	-50.4%

IBM had been getting about 3% extra growth for EPS due to share repurchases. That already became a headwind in 2020.

Pool Corp. (POOL) EQ Review- 9/20 Qtr.

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

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

We are initiating earnings quality coverage with a 4+ (Acceptable) rating.

POOL has been the unexpected beneficiary of the stay-at-home phenomenon as families locked in their homes invested in recreational activities. Skyrocketing new pool construction and strong homebuilding provided the perfect environment for the sales of the company's pool materials and supplies and its irrigation and landscaping products. Sales growth jumped to 27% in the 9/20 quarter from its usual 6-9% range and margins benefitted from the increased triggering of volume purchase discounts and cost-cutting. The company raised guidance for the full year to $8.20-$8.50 from its previous $7.05-$7.45.

Overall, we have little concern about the company's recent earnings quality. We would like to see more detail disclosed around the company's vendor incentive accruals and lack of visibility there is the main reason we did not award a rating of 5 (Strong).

What concerns us?

- Inventories are at low levels. Rebuilding will be a significant use of cash in 1H'21. More importantly, low product availability may limit the company's ability to take advantage of expected higher than normal price inflation through buying ahead of price increases and passing the product along at the inflated price.

- Margins have benefitted from increased buying triggering volume purchase discounts. This may make for difficult comps in the second half of next year.

- POOL accrues for the expected amount of volume purchase discounts expected to be received and revises its estimates throughout the year. There is minimal disclosure surrounding these accruals but we estimate periodic changes could potentially move quarterly results a few cents.

- Lower bad debt provision added about 3 cps to earnings in the quarter, but this was well below the earnings beat in the period so our concern level is low.

What is strong?

- POOL has utilized strong cash flow to reduce debt to below 1 times EBITDA.

What to watch

- Strong backlog at its pool builder customers along with restocking shelves at distributors should pave the way for a strong first half in 2021. However, difficult comps start in the back half.

- Strong earnings growth resulted in a $20 million increase in incentive compensation in the 9/20 quarter. This was more than offset by expense cuts and operating leverage. The company will incur some of these delayed expenses in 2021, but management expects this to be offset by a $15-$20 million tailwind from lower incentive compensation.

- POOL maintains a receivables securitization facility where it pledges receivables against short-term financing. These receivables stay on the company's balance sheet. Days sales of total receivables have remained relatively stable and the company is not increasing the use of the facility as a source of cash. Nevertheless, this is a point to monitor going forward.

A Quick Note on Performance Year-to-Date

Accelerated Sales Growth

POOL's longer-term sales growth target is in the 6-9% range generated by price inflation, greenfield expansion, and new product introduction. In 2020, the company was an unexpected beneficiary of the stay-at-home trend as homeowners invested in new pool construction as a way to recreate at home and people with existing pools utilized their pools more which required more maintenance spending. Also, the company's irrigation and landscaping products have benefitted from strong housing construction and renovation. This has led to sales growth rising well above trend for the last three quarters:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Revenue	$1,139.229	$1,280.846	$677.288	$582.233
growth	26.8%	14.2%	13.4%	63.6%

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Revenue	$898.500	$1,121.328	$597.456	$355.972
growth	10.7%	6.0%	2.0%	-30.2%

Note that most of the company's sales come in the seasonally warmer June and September quarters which makes growth rates and margin movements in the December and March quarters more volatile and less meaningful.

Management has indicated that the rush of demand has left many pool contractors with huge backlogs that will help to drive sales growth into the first half of 2021. This plus restocking the channel for maintenance products should support growth until difficult comps hit the back half of the year.

Gross Margin Trends

POOLs gross margin in its seasonally high quarters (June and September) is typically very stable and this proved true in 2020:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Gross Margin	28.9%	29.2%	28.0%	27.8%

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Gross Margin	28.7%	29.5%	29.2%	45.1%

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Gross Margin	29.0%	29.2%	28.3%	28.5%

Management noted that gross margin improvement in the 9/20 quarter was due to the company triggering volume purchase discounts which was partially offset by a shift to lower-margin equipment sales. POOL will be spending to replenish its inventories (discussed below) which should help it continue to trigger volume discounts in the first half although comps will become more difficult in the back half.

However, another way the company boosts its margins is through buying ahead of expected price increases and selling the inventory to customers at the inflated price. Price inflation is expected to be 2-3% in 2021 which is ahead of the typical 1-2% increase, but management indicated on the third-quarter conference call that product availability may limit its ability to take advantage of the buy-ins this year.

SG&A

Selling general and administrative expenses were down 130 bps as a percentage of revenue in the 9/20 quarter:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
SG&A % of Sales	15.8%	13.1%	21.7%	23.4%

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
SG&A % of Sales	17.1%	14.1%	22.8%	37.8%

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
SG&A % of Sales	17.6%	13.9%	22.6%	25.1%

POOL initiated cost-control measures which resulted in normal operating expenses increasing only 5% in the quarter on a 27% sales increase. However, the benefit of operating leverage was largely offset by a $20 million increase in incentive compensation in the 9/20

quarter due to the strong earnings performance which itself amounted to a 160 bps drag on margins. The company has delayed some expenses such as hiring which it will have to reverse in 2021, but management expects this to be offset by a $15-$20 million tailwind in 2021 due to incentive compensation comparisons improving.

Inventory Is Down and Will Have to Build Which Will Consume Cash and Potentially Limit Pricing

As noted above, while many other consumer discretionary names have suffered from COVID-related spending cuts, POOL has been a major beneficiary of the stay-at-home phenomenon as people looking to invest in things to do around their homes drove a huge jump in pool construction in the last two quarters. Historically, replacement and refurbishment account for about 25% of pool industry spending, new pool construction about 15%, and maintenance and minor repair (primarily chemicals) for the remaining 60%. Management noted in the third-quarter conference call that sales of new construction and refurbishment products such as heaters, pumps, filters, and lighting rose by 36% in the quarter. While not up as much as construction-related products, POOL's chemicals sales still rose 9% in the quarter.

This unusual demand has led to the company selling out its inventory to levels (relative to sales) not seen in years. The following table shows inventory days of sales (DSIs) for the last twelve quarters:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Total Inventory	$612.824	$628.418	$858.190	$702.274
Cost of Products Sold	$810.531	$907.365	$487.659	$420.184
DSI	69.6	63.0	160.1	153.8

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Total Inventory	$616.217	$694.447	$815.742	$672.579
Cost of Products Sold	$640.569	$791.014	$422.825	$382.640
DSI	88.5	79.9	173.6	161.7

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Total Inventory	$609.983	$606.583	$703.793	$536.474
Cost of Products Sold	$576.308	$749.149	$419.827	$364.785
DSI	97.4	73.7	150.9	135.3

At under 70, DSIs were substantially below their historical norms for a September quarter. The inventory takedown was a tailwind to cash flow growth in the last two quarters. Looking at the first nine months of the year, the movement in inventories added $99.8 million to cash flow growth versus $68.8 for the first nine months of 2019. This increase accounted for a little over 20% of the cash flow growth in the period. This tailwind will reverse over the next couple of quarters as the company rebuilds inventory to fill the backlog its customers currently have.

Management noted another potential negative related to its low inventories in the conference call. As a distributor, a common way the company boosts its margins is buying ahead of expected vendor price increases and then selling the inventory to customers at an inflated price. Product price inflation typically runs around 1-2%, but the company is expecting 2-3% for 2021. However, given the pressure its vendors are facing to fill their backlog created by the unexpected demand surge, the company may not be able to acquire as much inventory as it would like to take advantage of the situation. Consider the comment from the call:

> *"So, inflation looks to be a little bit higher next year, 2% to 3% versus the 1% to 2% normal. And we typically try to buy a little bit more when that happens. But vendors are struggling a bit to stay up with demand. So, it's not clear that we'll have as much opportunity as we might, otherwise, like to benefit from that."*

Vendor Program Benefit

Another recent boost to gross margins has come from the company's vendor programs. These are arrangements whereby the company gets credits from its suppliers for hitting certain purchasing volume targets throughout the year. The company estimates how much product it expects to buy based on its sales outlook for the year. It accrues the estimated rebates every month. Rebates are accounted for as reductions to the prices paid for inventory and are reflected in the income statement at the time the inventory is sold.

Estimates are continually revised as the sales outlook changes which can result in the company recording quarterly catch-up adjustments. Consider the company's description of its vendor program accounting from the 2019 10-K:

"Many of our vendor arrangements provide for us to receive specified amounts of consideration when we achieve any of a number of measures. These measures generally relate to the volume level of purchases from our vendors, or our net cost of products sold, and may include negotiated pricing arrangements. ***We account for vendor programs as a reduction of the prices of the vendor's products and therefore a reduction of inventory until we sell the product, at which time we recognize such consideration as a reduction of cost of sales in our income statement.***

Throughout the year, we estimate the amount earned based on our expectation of total purchases for the fiscal year relative to the purchase levels that mark our progress toward the attainment of various levels within certain vendor programs. We accrue vendor program benefits on a monthly basis using these estimates provided that we determine they are probable and reasonably estimable. *Our estimates for annual purchases, future inventory levels and sales of qualifying products are driven by our sales projections, which can be significantly impacted by a number of external factors including changes in economic conditions and weather. Changes in our purchasing mix also impact our estimates, as certain program rates can vary depending on our volume of purchases from specific vendors.*

We continually revise these estimates throughout the year to reflect actual purchase levels and identifiable trends. As a result, our estimated quarterly vendor program benefits accrual may include cumulative catch-up adjustments to reflect any changes in our estimates between reporting periods. These adjustments tend to have a greater impact on gross margin in the fourth quarter since it is our seasonally slowest quarter and because the majority of our vendor arrangements are based on calendar year periods. *We update our estimates for these arrangements at year end to reflect actual annual purchase levels. In the first quarter of the subsequent year, we prepare a hindsight analysis by comparing actual vendor credits received to the prior year vendor receivable balances. Based on our hindsight analysis, we concluded that our vendor program estimates were within a range of acceptable estimates and that our estimation methodology is appropriate."*

Management simply noted in the conference call that gross margins *"are benefiting from volume-related purchase incentives this quarter, with some of that gain being offset by the heavier mix of lower-margin equipment and an unfavorable customer mix."* Given the low

level of inventories, it is likely that the company will trigger its volume discounts in the first half of the year, although the second half may be more difficult.

Although the accounting for vendor programs is cited in the company's 10-K as a critical accounting estimate, POOL does not quantify the accruals in its quarterly filings. However, it does quantify the receivable associated with the programs in the 10-K in its breakout of accounts receivables. Note that these are the receivables on the balance sheet at year-end and do not include amounts pledged against its receivable securitization program:

	12/31/2019	12/31/2018
Trade Accounts	$18.455	$16.451
Vendor Programs	$59.228	$57.304
Other, net	$4.437	$1.920
Total Receivables	$82.120	$75.675
Allowance	-$5.472	-$6.182
Net Receivables	$76.648	$69.493

We know that the vendor program agreements are mostly on a calendar year basis. Therefore, the rebate receivable left at the end of the year and the actual rebates accrued for are likely considerably larger than the receivables balance. POOL's cost of sales in FY 2019 was $2.3 billion. If we assume about 75% of that was for purchases of products, and we assume that the potential volume rebate discounts that could be earned approximated 10%, that gives us an estimated potential accrual balance of about $170 million. A 1% change in the estimate of vendor rebates amounts to about $1.7 million or 3.3 cps. So, changes in this assumption have the potential to materially impact earnings in a quarter. Such potential manipulation has not been relevant in recent quarters given the circumstances with unusual demand and the size of recent earnings beats. Also, as the company noted in its disclosure, the fourth quarter is the most likely to be impacted given that it squares the actual experience against the estimate. Still, we believe it would be appropriate for management to disclose more information regarding the accrual level and the size of any changes in the accrual from quarter to quarter.

Receivables Securitization Facility

POOL maintains an accounts receivable securitization facility to enhance its working capital management. This is a true securitization facility under which POOL transfers receivables to a wholly-owned finance subsidiary which pledges the receivables as collateral against short-term financing. The receivables remain on the company's balance sheet as a separate line item rather. This is unlike a factoring program where the receivables are sold to third parties and removed from the company's financial statements. Our concern with receivables factoring programs is the potential to hide a buildup in accounts receivable from investors who only track the headline number on the balance sheet. We also are watchful for situations where companies rapidly grow their factoring activity which provides a temporary boost to cash flow growth. A close look shows that neither of these points are concerns for POOL at the moment.

First, let's examine days sales outstanding (DSOs) for both trade receivables and receivables pledged against the facility:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Revenue	$1,139.229	$1,280.846	$677.288	$582.233
Receivables	$135.555	$144.842	$66.328	$76.648
Receivables Pledged Under Facility	$230.857	$308.563	$279.587	$149.891
Receivables DSOs	10.9	10.3	8.9	12.1
Receivables Pledged Under Facility DSOs	18.6	21.9	37.6	23.7
Total Receivables DSOs	29.6	32.2	46.5	35.8

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Revenue	$898.500	$1,121.328	$597.456	$355.972
Receivables	$95.971	$127.260	$72.352	$69.493
Receivables Pledged Under Facility	$211.827	$289.866	$240.775	$138.308
Receivables DSOs	9.8	10.3	10.9	18.0
Receivables Pledged Under Facility DSOs	21.7	23.5	36.3	35.7
Total Receivables DSOs	31.5	33.9	47.2	53.7

Remember from the above discussion on vendor rebates that the receivables balance not pledged to the facility in both December quarters included about $60 million of vendor rebate receivables. We assume that the rebate receivables are much lower in other quarters as the company has not earned the rebates until closer to the end of the year. Therefore we believe the receivables balances in the key June and September quarters are mostly made up of trade receivables.

DSOs have been relatively stable year-over-year without a significant change in the mix of receivables pledged against the facility. POOL states in its filings that "we generally require payment from our North American customers within 30 days, except for sales under early buy programs for which we provide extended payment terms to qualified customers." The movement in receivables DSOs have generally been consistent with this policy over time and we see no evidence of the company becoming more aggressive with payment terms to drive sales in recent history. Note that receivables DSOs in the March and December quarters must be "taken with a grain of salt" given the extreme seasonality of the business. DSOs build well above 30 in those quarters as revenues drop off in the winter months. However, a jump in DSOs above 30-35 in the June or September quarters would be alarming.

With regards to boosting cash flows, POOL has received no unusual growth through its receivables facility by rapidly expanding factoring activity as several companies we follow have. POOL's receivables facility has been a long-term feature of its short-term financing strategy. Receivables pledged against the facility on the balance sheet do not reflect amounts sold, but rather balances that have been earmarked as collateral. The company discloses the amount outstanding under the facility at the end of each quarter:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Outstanding Under Receivables Facility	$110	$235	$195	$115

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Outstanding Under Receivables Facility	$161	$230	$175	$109

Outstanding amounts shows a relatively even use of the facility with the company even reducing the borrowing in the 9/20 quarter.

Given the above, we do not see an unusual risk from or dependence on increasing utilization of receivables securitization to drive cash flow growth. Going forward, points to monitor would be the trend in total receivables DSOs, watching for any indication that the company is utilizing payment terms to drive revenue growth. Any unusual expansion in borrowing against the facility would also be a red flag.

Decline in Provision for Bad Debts

POOL discloses not only its ending allowance for doubtful accounts, but also quarterly bad debt expense and write-offs as shown in the following table:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Beginning Allowance	$5.958	$7.728	$5.472	$6.179
Bad Debt Expense	-$0.329	-$0.261	$2.257	$0.129
Write-Offs Net of Recoveries	-$0.334	-$1.509	-$0.001	-$0.836
Ending Allowance	$5.295	$5.958	$7.728	$5.472
Total Accounts Receivable, Net	$366.412	$453.405	$345.915	$226.539
Allowance % of Gross Receivables	1.42%	1.30%	2.19%	2.36%
Bad Debt Expense % of Sales	-0.03%	-0.02%	0.33%	0.02%

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Beginning Allowance	$6.415	$5.645	$6.182	na
Bad Debt Expense	$0.993	$1.190	$0.456	na
Write-Offs Net of Recoveries	-$1.229	-$0.420	-$0.993	na
Ending Allowance	$6.179	$6.415	$5.645	$6.182
Total Accounts Receivable, Net	$307.798	$417.126	$313.127	$207.801
Allowance % of Gross Receivables	1.97%	1.51%	1.77%	2.89%

The company increased its reserves at the end of the 3/20 quarter in anticipation of a slowdown from COVID. Instead of a slowdown, installation of new pools skyrocketed as people stuck at home invested in activities they could do around their houses. This led the company to write back some of the reserve into earnings in each of the last two quarters. We estimate that if the provision expense had remained constant as a percentage of revenue, it would have taken about 3 cps off EPS in both the 9/20 and 6/20 quarters. We do not view this as purposeful earnings manipulation by management given the circumstances, and the 3 cps boost is was not material to the earnings beats in either of the last two quarters. This is a point to continue to monitor, but our concern level with this issue is low.

Explanation of EQ Rating Scale

Rating	Explanation
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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