BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Cadence Design Systems, Inc. (CDNS) Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

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

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

Summary

Overall, we see no significant problems with CDNS's earnings quality. The company recognizes the bulk of its revenue over time and deferred revenue days have been trending up which is

generally a positive. The remaining performance obligation has also been trending up which bodes well for future revenue recognition.

While CDNS has seen negative impacts from COVID, it has also benefitted from an unexpected boost to growth from some Chinese customers ordering hardware ahead of upcoming export restrictions. These hardware sales are recognized upfront and help to boost operating margins. Reducing other expenses such as travel has also helped margins. R&D spending, while robust, was still lower than expected in the third quarter due to delays in hiring. These all led to an increase in operating margins of more than 400 bps in the quarter. These items will reverse in the first half but in our view, the company has done a good job of laying this out for investors to see.

With regards to earnings quality, we note the following:

What is strong?

- About 85-90% of revenue is recurring and recognized over time. The company has determined that its software licenses that include maintenance and support are a single performance obligation which leads to all of the associated revenue being recognized over time rather than having the license portion being recognized upfront. This is a good sign for the quality of reported earnings.

- Deferred revenue days have risen significantly YOY in the last few quarters. While this could have been boosted some by acquisitions, we suspect that this was at least partially due to a shift to contracts billed annually from quarterly. Regardless, this bodes well for reported revenue in the near-term.

- The remaining performance obligation has been growing which also indicates continued growth in revenue in upcoming quarters.

What is weak?

- Like most tech companies, CDNS adds back the amortization of acquired intangibles to its non-GAAP results. We are critics of this practice as it disregards the cost of acquisitions. CDNS made two minor acquisitions in the first quarter of 2020, none in 2019 and 2018, and two minor deals in 2017. It is not as dependent on acquisitions for growth or obtaining technology as some in the sector. Free cash flow after the buyback has covered all acquisition spending the last few years. CDNS's adjustment also boosts non-

GAAP results by about 6-7% so it is not as large as many we see. So, while we are negative on the practice, the distortion is not as large a concern as it is for some of its peers.

- CDNS also adds back stock option expense which boosts non-GAAP results by about 25%. We are always negative on adding this expense back as the company would have to pay cash to its employees if it terminated the options plans and it must spend cash to buy back shares to avoid dilution.

- CDNS capitalizes the costs to obtain contracts which largely consist of commissions and amortizes them over 2-3 years. Many of its peers do this and the amortization period is relatively short compared to others. However, the company only discloses detail on capitalized balances and amortization on an annual basis and we would prefer to see this detail quarterly.

- The company has incurred $4-6 million in acquisition and integration charges over the last four quarters presumably related to its first-quarter acquisitions. These amounts are added back to non-GAAP results. However, it was adding back $1-$2 million acquisition and integration charges prior to that even though the last sizeable deal was done in 2017. This casts some doubt on how “one time” these charges really were. $2 million in charges amounts to about a penny per share, so these amounts are not especially material, but we will be watching for unusual spikes in these adjustments going forward.

Supporting Detail

Deferred Revenue Trends Appear Strong

Between 85-90% of the company’s revenue is considered recurring in nature. This includes revenue recognized over time from software deals, services, royalties, and maintenance on IP licenses and hardware. The balance of revenue such as sales of hardware and individual IP licenses is recognized upfront. According to the company’s SEC filings, revenue under time-based software agreements “are generally invoiced in equal, quarterly amounts, although some customers prefer to be invoiced in single or annual amounts.”

We note that CDNS has elected to consider licenses and support under its software arrangements to be a single, combined performance obligation which results in those revenues being recognized over time. This is a plus for earnings quality and predictability since if the

company had determined that the license portion was separate, it would have resulted in the company recognizing that portion of revenue upfront.

A key measure to track in assessing the quality of CDNS's reported revenue is deferred revenue relative to sales. The calculation of deferred revenue days is shown in the table below for the last eight quarters:

	9/26/2020	6/27/2020	3/28/2020	12/28/2019
Revenue	$666.607	$638.418	$617.957	$599.555
Total Deferred Revenue	$561.649	$582.376	$521.119	$428.883
Deferred Revenue Days	76.7	83.0	76.7	65.1

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Revenue	$579.603	$580.419	$576.742	$569.850
Total Deferred Revenue	$392.136	$420.872	$397.063	$401.174
Deferred Revenue Days	61.6	66.0	62.6	64.1

We can see that deferred days have shown a significant YOY increase for the last three quarters. The increase in the 9/20 quarter is even more notable given that the company cited an unusual uptick in hardware and IP sales from China ahead of upcoming export restrictions. The bulk of this revenue would have been recognized upfront and put downward pressure on the deferred days calculation.

Note that the company acquired AWR on 1/15/20 and Integrand Software on 2/6/20 for a total spend of $195.6 million. We do not know how much of the purchase price was allocated to deferred revenue, but it could have played a minor role in the increase in deferred days to the extent the acquired companies defer a larger percentage of their revenues than CDNS' core operations do.

A more likely factor that could be impacting the deferred revenue days trend is a change in the timing of contract billings. Remember that the company generally bills time-based software agreements quarterly. This is reflected in the fact that deferred revenue days are in the 70s. However, if there was a shift towards contracts that were billed annually, then CDNS would have received more cash upfront which would boost deferred revenue relative to revenue recognized on the income statement. Regardless, we take the increase in deferred days as a positive for earnings quality.

Another indication of the growth in the company's core business is the trend in the remaining performance obligation (RPO). The RPO represents the value of contracts that have not been

recognized in revenue and includes deferred revenue as well as unbilled amounts under contract. The following table shows RPO for the last eight quarters:

	9/26/2020	6/27/2020	3/28/2020	12/28/2019
RPO	$3,800	$3,700	$3,700	$3,600

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
RPO	$3,000	$2,800	$2,800	$2,900

Note that the company voluntarily removed $70 million from its backlog at the end of the 6/20 quarter as the realization of those amounts became questionable due to the impact of COVID. It added about $12 million of that back to RPO in the 9/20 quarter. Regardless, the trend in backlog is solidly positive which bodes well for near-term future revenue growth.

The fourth quarter will be a 14-week period which will add about $45 million to revenue versus the year-ago fourth quarter. Also, the company expects about $40 million in incremental hardware sales from China in the second half of 2020 which likely represents Chinese customers getting in ahead of new upcoming technology export bans. The midpoint of the company's revenue guidance represents about 14% growth after backing out the impact of the extra week. It remains to be seen how much of the recent bookings were pulled forward into the second half of 2020 due to the export restrictions and will no repeat in the first half of 2021.

Adding Back Amortization of Intangibles- Not as Big a Problem as It Is for Some

As is typical for tech companies, CDNS adds back the amortization of intangible assets picked up in acquisitions to its non-GAAP earnings figures. The following table shows these amounts relative to non-GAAP pre-tax income for the last eight quarters:

	9/26/2020	6/27/2020	3/28/2020	12/28/2019
Amortization of Acquired Intangibles	$15.885	$16.074	$15.066	$12.660
% of non-GAAP Pretax	*6.8%*	*7.3%*	*7.6%*	*7.0%*

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Amortization of Acquired Intangibles	$12.799	$14.458	$13.162	$12.942
% of non-GAAP Pretax	*7.0%*	*7.5%*	*7.3%*	*7.4%*

CDNS is not highly dependent on acquisitions for growth. The company made two acquisitions in the first quarter of 2020 for a combined purchase price of less than $200 million. There were no major deals done in 2018 and total acquisition spending in 2017 was only $142 million. Spending on acquisitions has not exceeded free cash flow after the buyback at any time during the last three years. Also, the company is not dependent on acquiring its technology as its R&D as a percentage of revenue runs in the upper 30% range which is generous even for the software industry. Regardless, adding back amortization distorts economic reality by disregarding the actual cost of the deals.

Stock Compensation Added Back

Like most tech companies, CDNS also adds back stock-based compensation to its non-GAAP results. The following table shows these amounts relative to non-GAAP pre-tax income for the last eight quarters:

	9/26/2020	6/27/2020	3/28/2020	12/28/2019
Stock Based Compensation Expense	$45.334	$46.907	$46.482	$46.758
% of non-GAAP Pretax	*19.3%*	*21.3%*	*23.5%*	*25.9%*

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Stock Based Compensation Expense	$48.279	$44.257	$42.253	$42.594
% of non-GAAP Pretax	*26.6%*	*23.1%*	*23.3%*	*24.4%*

While not the highest we have seen, CDNS' stock compensation expense is substantial relative to profits. Our standard argument against this practice is the fact that the company would have to pay its employees cash if it were to eliminate the options awards. Also, the company must spend cash to repurchase shares to avoid dilution, so ignoring these costs is overstating the actual returns on the business.

Regular Acquisition and Integration Costs

Another non-GAAP adjustment is the adding back of "acquisition and integration-related" costs which are shown in the table below.

	9/26/2020	6/27/2020	3/28/2020	12/28/2019
Acquisition and Integration-Related Costs	$6.739	$5.315	$3.970	$3.466
% of non-GAAP Pretax Income	2.9%	2.4%	2.0%	1.9%

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Acquisition and Integration-Related Costs	$1.838	$1.889	$0.914	-$1.360
% of non-GAAP Pretax Income	1.0%	1.0%	0.5%	-0.8%

The company does not give much color on what is included in these charges. We can assume that the spike in costs in the 12/19 quarter was due to pre-deal costs related to the two acquisitions made in the 3/20 period. But keep in mind that before that, the last acquisition of any size was made in 2017. The fact that these costs were still being identified and added back calls into question how “one-time” these items really were. The concern is the possibility that costs such as management time spent on the deals are being included in these charges and dismissed by those focusing non-GAAP earnings. For reference, every $2 million in expenses added back adds about a penny per share to non-GAAP results. We will continue to monitor these charges going forward and will be concerned by unusual spikes in amounts added back.

Conagra Brands, Inc. (CAG) Earnings Quality Review 11/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of CAG with a 2+ (Weak) rating.

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

Summary

Conagra beat 2Q21 forecasts by 7-cents. Sales exceeded consumer sell-through again. CAG did not quantify it this quarter, but this allowed the company to boost sales and leverage fixed costs. In 1Q21, this was 600bp of sales growth. **Every 100bp of that type of demand helped 2Q21 EPS by 1-cent and we think this was 3-4 cents of EPS**. **Every 25bp of gross margin pick-up from leveraging fixed costs adds 1-cent** too. 2Q21 saw 140bp of gross margin gain. **Plus, every 25bp of pricing added another 1-cent** and pricing was up 150bp with help from reduced in-store marketing. 3Q21 guidance expects only a 30-80bp y/y pick-up in operating margin vs. 250bp in 2Q – the number one reason given was CAG expects less operating leverage. CAG picked up considerable EPS in 1Q21 from reversing a marketing accrual. It guided to higher marketing expense for both in-store promotions and in general for 2Q. The first was down again and the second was flat – both helping EPS. Lower travel expenses added 1-cent more and CAG offset higher incentive pay with wage and 401(k) cuts. Of course, **there were more never-ending restructuring charges and those were added back for 3-cents in EPS.**

What is strong?

- COVID helped CAG tremendously by clearing the stores and warehouses of inventory that likely would have required big mark-downs. Inventory ended 2Q20 at 106 days of sales and bottomed at only 58 days in 4Q20 (May). It finished at 70 days for 2Q21. The reason for the plus on our rating is we believe CAG could still pick up some operating

leverage beyond current guidance by rebuilding its inventory in 3Q which could help replace lower retail channel stocking as a reason to outproduce demand.

- CAG has a very easy comp for sales for 3Q21 of -1.7% which includes -1.3% on volume. That is the last one for some time going forward. Historically, that was when the company was able to post positive organic growth.

What is weak?

- CAG's organic growth is already falling rapidly. The last two quarters were helped by restocking the retail channel and lower in-store marketing cost that is netted against sales. Historically, CAG's sales sit in a range of -2% to +2% y/y change. Guidance of 6%-8% growth for 3Q21 looks high to us after 2Q's 8% figure as the primary restocking demand figure is easing.

- Guidance for very little pick-up in y/y margin for 3Q21 is troubling too – 30-80bp vs. 250bp in 2Q21. One of the reasons given is seasonally slower sales are expected which would deleverage fixed costs on production. With retailers still building inventories and CAG looking to expand its own inventory on hand, that should create enough short-term production increases in our view to create higher operating leverage.

What to watch

- Cost inflation is growing. CAG saw inflation of 3.1% in 1Q and guided to low-mid 2%. It came in at 2.8% in 2Q and now the company is guiding to 3.5%. We think that will come out of CAG margins going forward because retailers are still investing in price and pushing their private label products.

- Investors do not have to go back very far to find CAG results when it tries to take pricing and retailers do not. It happened in 2019 when CAG lost market share, had large drops in volume, even took impairment charges against particular brands, and cut guidance repeatedly.

- For all the synergy and cost-cutting work that CAG touts – we continue to see the bulk of their gains coming from culling lower-margin units (about 400bp of margin) and cutting advertising (about 100bp of margin). COVID has let CAG stretch that rubber band further

with even deeper advertising cuts. That seems likely to snap back and hurt margins. Even CAG is guiding to that.

- There may be other headwinds for EPS going forward beyond advertising increasing. Travel and entertainment costs should return. CAG will lap the cost savings from layoffs and it notes that remaining employees are earning more.

Supporting Detail

Can CAG Maintain Its Sales Gains Beyond this Quarter?

4Q20 and 1Q21 were the key parts of COVID-related demand with customers doing pantry stocking for the May quarter that was 4Q and that continuing in the August 1Q along with retailers restocking. CAG guided to 6%-8% growth for the November 2Q.

Organic Growth	2Q21	1Q21	4Q20
Volume	6.6%	10.9%	21.0%
Pricing	1.5%	4.1%	0.5%
Total Org. Growth	8.1%	15.0%	21.5%

We think it is important to focus on a few factors for these results:

- In 1Q21, the company noted that 600bp of its volume came from stores restocking inventory. That was actually lighter than what CAG could have achieved if was not supply-constrained itself according to management.

- In 2Q21, CAG did not quantify the amount of volume due to restocking the channel but acknowledged that it did help drive 2Q volume. It specifically called out Birdseye as a large product area that was not able to fully fill orders in 1Q that saw the restocking bleed into 2Q.

- We can see Kroger's figures that show this big restocking demand. Inventories have been lower on higher sales for much of 2020:

Kroger Inventory	Nov. 20	Aug. 20	May. 20	Feb. 20
Inventory	$7,478	$6,344	$6,297	$7,084
COGS	$22,901	$23,551	$31,454	$22,507
Inventory DSIs	29.8	24.6	18.3	28.7

	Nov.19	Aug. 19	May. 19	Feb. 19
Inventory	$7,412	$6,526	$6,707	$6,846
COGS	$21,798	$22,007	$28,983	$21,955
Inventory DSIs	31.0	27.1	21.1	28.5

- In our view, Kroger was still 2.5 days below normal after 1Q and closed that gap to 1.2 days after 2Q. Wal-Mart also commented that it was restocking inventory in the quarter that ended in October 2020. **We think this restocking continues to help for 3Q21 – but not to the same extent.**

- We believe if CAG's actual volume growth apart from industry channel stocking in 1Q21 was closer to 5% vs. the reported 11% - then 2Q21's 6.6% may be closer to 2% and CAG admits some of the restocking continued in 2Q.

- **Pricing appears even more unsustainable than volume. CAG reports pricing net of in-store promotional spending.** The company used to disclose the percentage of sales drag from promotional spending but not these days.

- In 1Q21, CAG reversed an accrual of in-store spending which added 70bp to sales. We also know that in 1Q20 the spending was a 170bp drag on sales. The net change in pricing y/y in 1Q21 was 410bp. However, 240bp came from this change to in-store promotion, so the real pricing power was only 170bp.

- Guidance for 2Q21 was that in-store promotion would increase, from the 1Q21 call, "***we expect to increase our marketing support both above the line [in-store spending that nets against sales] and below the line [in SG&A].*** *We believe there are opportunities to increase brand-building investments where capacity permits.*"

- In 2Q21, CAG actually spent less in this area, 2Q21 call, *"organic net sales was primarily driven by a 6.6% increase in volume related to the growth of at-home food consumption. The favorable impact of price mix, which was evenly driven by favorable sales mix and **less trade merchandising** also contributed to our growth."*

- 2Q21 said pricing increased 150bp. For 2Q20, trade spending was a 120bp drag. The company did not quantify how much it fell in the 10-Q or the earnings call. We simply know it was lower than the prior year after guiding for an increase.

EPS Impacts and Conclusions on Sales Issues

We believe CAG will need to boost in-store promotion going forward. If that occurs it will become a drag on y/y pricing changes. In 1Q21 – 240bp of sales from promotional changes generated over 8-cents in EPS. In 2Q21 – the benefit was likely less than that. It was not quantified, but every 25bp change produced 1.1-cents in EPS. **We would not be surprised if CAG picked up 2-cents on lower promotional spending in 2Q21.**

The volume gains from restocking the channel should help the current quarter still. However, this benefit should also be waning. In 1Q21, this was 600bp of sales. Using operating margins as what fell to the bottom line – this added 3.5-cents to EPS. Using gross margins – this added 6.2-cents to the bottom line. The 1Q benefit should be somewhere between those figures.

For 2Q21, the restocking demand was not quantified. But we know CAG's volume growth is normally negative. In 2Q, volume growth was 660bp. Every 100bp from restocking added 1.3 cents based on gross margin or 0.9 cents based on operating margin. **We would not be surprised if CAG picked up 300-400bp in volume in 2Q given how much retailers were reloading inventory and added 3-4-cents in EPS.**

For 3Q21, CAG is guiding to 6%-8% organic growth. We think pricing will have a very minor impact on that guidance. The company is saying promotional spending will rise and that lowers pricing. Also, the operating margin guidance is only for a 30-80bp pickup for 3Q vs. 250bp in 2Q. Since price increases add almost no operating cost, we believe this points to little pricing power in this quarter.

On volume, it appears that the retail channel still needs more restocking but it should make a smaller impact in 3Q than 1Q or 2Q. Some of the volume growth should also come from the last easy comp that CAG will have. For 3Q20, CAG saw -1.7% organic growth driven by a -1.3% change in volume. We think investors should be concerned that CAG is guiding to lost operating leverage of fixed costs due to the normal seasonality where 3Q sales are below 2Q. A normalization may indicate the COVID inflated sales are vanishing. That is despite some additional channel building of inventory. That is also despite CAG needing to rebuild some of its own inventory levels as noted on the call, "***we are seeing orders that are strong because we're replenishing to be able to have the right stocks to support the demand***." We also think DSOs point to a need for CAG to grow its own inventory too:

Conagra Inventory	2Q21	1Q21	4Q20	3Q20
Inventory	$1,623	$1,580	$1,378	$1,647
COGS	$2,104	$1,868	$2,165	$1,844
Inventory DSIs	70.4	77.2	58.1	81.5

	2Q20	1Q20	4Q19	3Q19
Inventory	$1,770	$1,756	$1,563	$1,639
COGS	$1,530	$1,663	$1,838	$1,805
Inventory DSIs	105.6	96.3	77.6	82.8

We know 2Q20 inventory was too high, the prior year it was 99 days. We believe 70 is too low now and CAG is talking about building its inventory levels too. Between that production and more restocking in the retail channel, we would expect more fixed cost leverage. However, CAG is downplaying that in guidance. **Thus, there are conflicting issues on volume but with weaker pricing, CAG may need volume growth to accelerate y/y for 3Q. That may be tough difficult to achieve given how much recent volume growth was one-time in nature.**

Miscellaneous EPS Issues

It would not be Conagra without some special "one-time" items. For the adjusted EPS, 2Q21 was not too bad:

EPS Impacts in Adjusted Figures	2Q21 $mm	EPS Impact
Rise in Pension Benefit	$1.8	$0.3
Lack of Travel/Ent. Expense	$4.6	$0.7
Increase in Share Comp.	-$3.4	-$0.5
Increase in Incentive Comp.	-$9.7	-$1.5
Wages saved by layoffs, cut to 401-k	$12.5	$2.0
Total help to EPS	$5.8	$1.0

Our view is travel and entertainment spending should rise going forward. Also, the higher incentive pay should remain high in 3Q and then start to decrease as CAG faces tough comps and growth rates normalize. There is likely a greater headwind for 3Q than 2Q saw in those areas.

Also, cost savings from layoffs will lap soon too and we would expect CAG to boost 401-k spending following all the COVID impacts. The company even noted that the remaining employees are being paid more. All in all, this may go from a 1-cent tailwind for 2Q21 results to a 1-cent headwind for 3Q21.

As usual, CAG added back restructuring charges of 3-cents. This has been a recurring item for years, which by itself is aggressive – when does the restructuring become a normal part of the

company's operating model? Also, like an acquisition, where a company ignores the purchase price and integration costs but only touts the higher sales and lower per-unit costs – CAG has a similar situation here. It touts the cost savings from lay-offs and does not add those back, but the expenses incurred to achieve those savings are ignored.

Looking at advertising expense in SG&A (not the in-store promotion netted against sales). It is obvious to us that CAG continues to pick up EPS in this area. It was simply spending more money on advertising before it bought Pinnacle Foods. COVID allowed it to reduce spending further as sales were driven by panic buying and lockdowns. For a company that claims to be brand builders and likes to promote its products with a value over volume philosophy, this still looks like a future source of EPS headwinds. Every $6 million in higher advertising is 1-cent in lower quarterly EPS:

Conagra Advertising	4Q	3Q	2Q	1Q
fiscal 21			$63.6	$45.9
fiscal 20	$59.2	$65.5	$60.7	$45.3
fiscal 19	$73.9	$67.4	$69.4	$42.7
fiscal 18	$59.5	$78.2	$86.0	$54.9
fiscal 17	$75.5	$90.7		

CAG spent $69.4 million on advertising in 2Q19 when it owned Pinnacle Foods for only a few weeks. Since that time, the combined company has only exceeded that figure in one quarter out of eight.

The GAAP tax rate fell due to CAG releasing a tax benefit valuation allowance of $25.2 million in 2Q21. This was worth 5.2 cents in EPS. This is a one-time item in our view. The benefit was removed from adjusted EPS and CAG used a comparable tax rate of 23.2% vs. 22.8% last year.

The Kroger Company (KR) Earnings Quality Update 10/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of KR with a 5+ (Strong) rating.

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

Summary

Kroger's 3Q showed much of the same story so we will keep this short. EPS beat forecasts by 5-cents as the company enjoyed higher sales and margins. We are pleased to see Kroger devote some of its higher COVID cash flow toward fixing its multi-employer pension obligations which will help future cash flow. Also, Kroger has retired about 20% of its stock in recent years at about 10x earnings. In 2017, to earn $3 per share on $122 million in sales, KR needed an operating margin before rent, depreciation, and interest of 6.15%. Today sales are higher with COVID and attracting new customers. But with the lower share count and lower leverage, KR can earn $3 per share with a 5.05% margin on the same $122 million in sales. If they keep sales at $125 million, they can earn $3 on a 4.95% margin. That is a ton of deleveraging of fixed costs if sales do decline that KR can withstand.

Earnings quality remains high as Kroger does not adjust out the COVID related costs for additional employees, overtime, incentive pay, cleaning, etc. Kroger has pulled out enormous costs in recent years but plowed back the savings into higher wages and lower prices. There should be millions in COVID-related costs that can decline with COVID sales levels too.

What is strong?

- When we first wrote KR, the over-riding negative issue was its exposure to multi-employer pension plan shortfalls. KR has been cleaning this up with additional payments along with withdrawing from plans it has funded. At the end of 2018, the KR share of the liability

was $3.1 billion. By the end of 2019, it was $2.3 billion. KR has used some of the COVID windfall profits and cash flow to further reduce this problem area. It announced in 4Q that it will withdraw from another plan and fund its remaining payments of $962 million over three years beginning in 2020.

- Funding for these multi-employer plans has been heavy in recent years: $236 million through 3Qs of 2020, $461 million in 2019, $385 million in 2018, and $954 million in 2017. KR will continue to make payments toward these plans, but the size of the problem is getting smaller and perhaps the end can be seen. Kroger's target for leverage is 2.3-2.5x EBITDA, and it was at 1.74x after 3Q20 so the liquidity is here and we applaud the company using some of it to remove some open-ended liabilities.

- Kroger remains one of the few companies we have seen that reports adjusted EPS that actually come in lower than GAAP EPS. GAAP was 80-cents in 3Q20 while adjusted EPS was 71-cents. The adjustments relate primarily to marking an investment in a logistics firm to market which was a 15-cent gain in 3Q, netted against 2-cents in higher contingent payments for the Home Chef acquisition exceeding forecasts (WOW a company that made two home-run acquisitions – investors don't see that every day), and 4-cents related to store closing fees.

- More importantly, Kroger does not add back COVID costs – which are elevated for extra warehouse space, overtime, extra employees, cleaning, and reconfiguring stores and all operating spaces. Kroger does not add back the costs to roll-out and expand its digital sales such as online ordering or waiving pick-up fees. It does not add back its investments in reducing prices to customers. They have talked about adding $1 billion in spending incrementally each of the last two years in these areas. That is nearly $1 in annual EPS that is compounding that Kroger is not adjusting back for a company earning about $3. The move is on to educate investors that the incremental sales are coming against already incurred fixed costs. Thus, the incremental $1 in sales is boosting profit by 25-cents rather than 5-cents.

What to watch

- The debate has begun on will Kroger lose sales and earnings as COVID demand wanes. We believe Kroger may have a transition quarter or two where it continues paying higher COVID related costs as sales normalize more – which could mean negative sales comps. In the larger picture, we believe Kroger has the potential to offset much of this with less overtime pay, fewer total employees and even charging for people who pick up their orders rather than go into the stores.

Some back of the envelope sensitivity analysis shows us that every $500 million in sales lost as COVID wanes would reduce quarterly EPS by about 2.6-cents. Sales were about $2.5 billion higher y/y in 3Q. So if sales normalize down $1.5 billion per quarter that's about 8-cents in lower EPS. Also, there is some margin leverage from the higher sales, and operating margin was 5.5%. Every 25bp lost on the remaining sales from margin contraction is about 6-cents in lower EPS too. Thus, if sales later in 2021 normalize at $1.5 billion less and 50bp of margin is lost – EPS would see pressure of about 20-cents per quarter. That assumes Kroger doesn't do anything to offset that like normalizing staff or seeing COVID costs decline or not needing as much warehouse space, or capping fuel subsidies at 10-cents per gallon, etc. Given how much extra cost is in the system now that could come out, we think non-COVID quarters will probably cost EPS by about 10-12 cents per quarter. Also, keep in mind – if you're comparing Kroger EPS before the RESTOCK program to now – they have retired 144 million shares at this point, that alone would boost EPS by 20% from what it was in 2017.

- Kroger did not see a huge issue with inflation after 3Q. It believes its operating model is built to absorb 0.5%-1.0% inflation without issues. It is seeing inflation of late at about 2% and much of that was due to COVID-related closures at meat facilities. If you like branded consumer product companies and branded food companies (Conagra comes to mind) – you may want to take note of the following things pointed out by Kroger on its call. **First, we know Kroger makes a higher profit margin on its own store-brand merchandise, which it sells for lower price to the consumer – which counters inflation. Kroger noted that its store brands took market share and grew at 8.6%** in 3Q with *Private Selection* growing at 17% and *Simple Truth* at 15%. It also introduced 250 new items.

  Second, Kroger all but said its way of handling cost inflation is pushing it back on the branded companies. The CEO said, *"**You're going to always work with CPGs initially to try to find ways to take costs out of the system, so that our customers don't have to have inflation.** And it's something that every CPG that partnership is a different approach in terms of trying to figure out a way to minimize the impact on customers."*

- Inventories remain below normal levels in our view. That should also help preserve some margin at KR, but we do expect them to in invest some cash flow in building stocks further and they have taken on more warehouse space.

Kroger Inventory	Nov. 20	Aug. 20	May. 20	Feb. 20
Inventory	$7,478	$6,344	$6,297	$7,084
COGS	$22,901	$23,551	$31,454	$22,507
Inventory DSIs	29.8	24.6	18.3	28.7

	Nov.19	Aug. 19	May. 19	Feb. 19
Inventory	$7,412	$6,526	$6,707	$6,846
COGS	$21,798	$22,007	$28,983	$21,955
Inventory DSIs	31.0	27.1	21.1	28.5

During 3Q, Inventory consumed $1.16 billion of cash flow at Kroger as it was already rebuilt. The higher earnings still enabled Kroger to post positive cash flow from operations in the quarter with help from rising payables too. We do not expect that level of inventory growth in 4Q.

Dentsply Sirona, Inc. (XRAY) Earnings Quality Update 9/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are raising our earnings quality rating of XRAY to a 3+ (Minor Concern) from 3- (Minor Concern).

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

Summary

We see some tailwinds for XRAY in the near term for 4Q20 and 1Q21. Inventory levels at the distributors look low and XRAY's own inventories are down. That should help drive more sales as business recovers and help leverage fixed costs on production to improve margin. Also, accruals on working capital items should return to normal levels and help EPS in the coming quarters after being sizeable headwinds in 2Q20 and 3Q20. If XRAY is successful in reaching even some of its cost-savings target from restructuring, that could also be a tailwind for earnings.

However, XRAY will likely need to boost R&D after cutting it in 2019 and likely deferring more in 2020. Also, margins in 3Q20 were still helped by employees working fewer hours, salary cuts, and lower selling-related expenses like travel. Those should return to normal as business picks up.

Overall, we are still not impressed with XRAY's future plan of reaching $4 billion in sales and a 22% adjusted margin. Doing so would put it back in the same position it was in during 2015-16 before years of restructuring. Also, that goal would only produce an ROI of 13%, which would only be that high because XRAY wrote off $2.9 billion in acquired goodwill in recent years. If the equity base didn't take that hit, the best-case ROI target would be 9%. Those forecasts would result in adjusted EPS of about $2.75-$2.85, with about $0.65-$0.70 of that EPS coming from adding back amortization of acquired intangible assets.

What is strong?

- A resolution may be near with the SEC. From the 10-Q, "*As previously disclosed, in 2017, the Division of Enforcement of* ***the SEC asked the Company to provide documents and information relating to the Company's accounting and disclosures****. The Company has been fully cooperating with the SEC in connection with its investigation.* ***The Company now is discussing a possible resolution of the investigation.*** *Any agreement reached with the staff would be subject to Commission approval. There is no assurance that a settlement will be reached, or whether it will have a material impact on the Company's consolidated financial position, results of operations or cash flows."*

- XRAY hit its 22% adjusted operating margin in 3Q20. Even the company believes that may be a short-lived situation as big parts driving achievement were employees working fewer hours and employees with pay cuts – which will vanish if sales recover further and those temporary measures canceled.

- Inventory levels at distributors look low, which could produce some restocking demand for XRAY.

- Eliminating two lower-margin businesses in traditional Ortho and Lab should boost operating margin at XRAY – which describes their profit contribution as immaterial.

What is weak?

- XRAY pointed to a tough comp from 3Q19 as a headwind for 3Q20 sales dropping y/y along with COVID. We would have expected stronger sales simply because 2Q20 was so awful with dentists closed and sales falling $519 million (51%) creating a huge amount of pent-up demand. We still see XRAY seldom reaching its target of 3%-4% organic growth.

- R&D spending declined in 2019 from $161 million to $131 million. That was 80bp of the company's margin gain that year. XRAY talked about deferring spending in 2020 which may have included R&D again. The goal at XRAY is to speed the development of new products so we would expect a large bump in R&D spending going forward, which may be an earnings headwind.

What to watch

- Another acquisition? XRAY bought Byte for $1.04 billion in cash two weeks ago. Byte is expected to be accretive in 2021 with about 5-cents in EPS added. The plan is to boost Byte's profitability by rolling its product out on XRAY's much larger distribution system.

- We would like to see the break-out of where the purchase price was allocated, which should be in the next 10-K. With $200 million in revenues, XRAY paid 5x sales and for a fast-growth business, the sellers took all cash rather than any XRAY shares. This deal will likely have considerable goodwill, which will not be expensed, and other intangible assets that XRAY will add back to adjusted EPS. That is why the deal will have a small accretion to EPS. On the call following the deal, XRAY noted that Byte will help it achieve its 3%-4% revenue growth target. The issue is the $200 million in sales is not organic growth.

- Cash flow benefited from working capital being reduced during COVID. This added over $300 million in cash flow in 2Q and 3Q. As business returns, we expect much of that to reverse. Before the Byte deal, XRAY had $1.3 billion in cash on hand against $2.2 billion in debt. Byte cut the cash balance by just over $1 billion. That combined with working capital building and restoring reduced capital spending may slow share repurchases for a few quarters.

- Sales to the Rest of the World (not the US or Europe) are about 25% of total sales at XRAY. This was the area first hit by COVID and after 3Q, it is not mirroring the bounce in sales from the other two regions. The stronger dollar against those currencies could continue to weigh on XRAY sales or force it to lower prices which would hurt margin targets.

Supporting Detail

Restructuring Cost-Saving Forecasts Should Have Margins Coming in Much Higher than XRAY's Touted Goal

XRAY has been restructuring since 2016 and its merger with Sirona. We are hard-pressed to see the results being promised or if investors should even be judging results based on XRAY's goals. The goal is to achieve 22% operating margins by 2022.

If we start in 2014 and 2015 and simply add the operations of Dentsply and Sirona together, the combined company was essentially at that level already:

First Merger	2015	2014
Dentsply Sales	$2,582	$2,793
Sirona Sales	$1,161	$1,171
Total Sales	$3,743	$3,964
Dentsply Adj. Op. Income	$521	$513
Sirona Adj. Op. Income	$289	$277
Total. Adj. Op Income	$810	$790
Adjusted Oper. Margin	21.6%	19.9%

The first step was restructuring after the merger and was expected to produce $125 million in synergies and cost savings. **That alone should have boosted margins to 24.9%.** XRAY was also expecting to produce 3%-4% organic revenue growth during this time. Neither situation happened:

XRAY Results	2019	2018	2017	2016	2015
Sales	$3,988	$3,949	$3,957	$3,855	$3,743
Internal Growth *	5.7%	-1.8%	-0.2%	2.4%	
Adj. Operating Income	$742	$614	$791	$804	$810
Adj. Operating Margin **	18.6%	15.5%	20.0%	21.8%	21.6%

*Internal growth for sales excludes FX, acquisitions, dispositions

**Adjusted Op. Margin excludes amortization of acquired intangible, restructurings, impairments

Sales in 2019 were about $400 million light of where organic growth projections should have had the company. Plus, operating margins were expected to benefit from $125 million in cost savings after the 2016 restructuring. Operating income adjusted for all the acquisition costs and problems was down in dollar terms and in margin terms.

In the 3Q18, XRAY announced another $250 million in restructuring that was forecast to produce between $200-$225 million in cost savings by 2021. On roughly $4 billion in sales, that would add 500-560bp to operating margins. This would get XRAY to a 22% operating margin by 2022. The bulk of the savings was expected to come from lay-offs. The company announced that 2019 had $89 million in savings realized. Margins grew by 310bp from 2018 to 2019. The $89 million is 220bp and XRAY cut R&D spending by $31 million adding another 80bp.

Now let's look at what happened in 2020. The restructuring was expanded again from a $275 million program to $375 million in scope and cost. The expected savings were raised from $200-

$225 million to $250 million or 625bp. With this incremental cost savings of 65-125bp, XRAY is forecasting the same margin target of 22% as before. The key to the enlarged restructuring is the company is exiting its traditional Ortho and Lab businesses. These two units had combined sales of $176 million and profits were immaterial. Exiting these businesses will result in a reduction of 6%-7% of the workforce. If profits were immaterial, it sounds like these units were lower margin than the rest of the company – which XRAY says in the 10-Q but does not quantify. Simply subtracting a lower margin unit should boost overall margins. So here's another tailwind that should materialize, yet where is XRAY setting its target – at the same 22% level!

To make this whole process even more suspect, the company was even hedging on the 22% figure on the 3Q call, which they reached in the quarter:

> "***we had laid out the target of 22% in 2022***. *Whether that target is exactly hit, given COVID and given where revenues potentially could fall in 2021,* ***it's still a little bit of a question for us.*** *I would tell you; we're really committed to that 22% number.* ***And obviously, look, we hit it this quarter. And I think we're trying to tell you guys that there have been excellent structural improvements, but there were some stuff that was like temporary work – short work week, furloughs and other things [non-permanent cost savings] that ramp down as we bring people back, and you're starting to see revenue****.*
> *I mean, we had a $900 million revenue quarter. There's –* ***we pay commissions and we pay dealers and all that stuff, so some of that [cost] comes back.*** *But the 22% margin is, in our mind, absolutely, A, attainable; B, it's really something we're committed to. And again, what the exact timing is, that could get pushed a little bit but we think we're going to get there."*

We continue to be astonished that XRAY started in 2016 with a 21.6% operating margin and done three major things designed to boost margins by over 300bp, 500bp, and now another 125bp. Yet, the goal is to get to an operating margin of 22% by 2022 where it was in 2015. Looked at another way, a 22% margin on $4 billion in sales is only $880 million in operating income without accounting for amortization of intangibles vs. $810 million in 2015. COVID or not, we're amazed XRAY is having a tough time battling to get to that $880 million figure after all the touted cost-cutting and focus on growth markets.

Allowances May Decline and Help EPS, Working Capital May Be a Headwind for Cash Flow

Some of the reserves against working capital have been working against XRAY's recent EPS. We would expect these reserves to decline going forward and become EPS tailwinds:

	3Q20	2Q20	1Q20	4Q19
Inventory Reserves	$126	$102	$96	$85
Finished Goods Inventory	$282	$322	$368	$356
Reserve %	44.5%	31.7%	26.1%	23.8%
Seq. Change EPS Impact (cents)	-8.6	-5.2	-0.4	

In our view, the reserve is most likely applied to finished goods inventory. Throughout 2019 and even until the start of COVID, this reserve has been about 25% of finished goods +/- 2%. The inventory figure is likely to rise again too. In has been about $390 million for finished goods in most quarters. That would mean a reserve of just under $100 million. **Even if the level of inventory rises, XRAY's reserve should decline. They have suffered an 8.6 cent headwind in 3Q20 and 5.2 cent headwind in 2Q20 against reported adjusted EPS of 67 cents in 3Q and -18 cents in 2Q.**

The bad debt reserve for accounts receivable looks similar, but the level of receivables is low too. Historically, the bad debt reserve has been 4%.

	3Q20	2Q20	1Q20	4Q19
Bad Debt Reserve	$31	$37	$31	$29
Accounts Receivable	$628	$500	$709	$782
Reserve %	4.7%	7.0%	4.2%	3.6%
EPS Impact from 4% (cents)	4.0	-5.3	-0.6	

If the reserve had been 4% during 2020, XRAY had a small headwind for EPS in 1Q, a 5.3 cent headwind in 2Q, and then 3Q would have benefitted by 4.0 cents on EPS vs. 2Q's $37 million reserve. Going forward we would expect receivables to rise as sales recover further. XRAY may not have a tailwind from bad debt reserves after enjoying the decline in 3Q.

For other items, XRAY saw stock compensation decline by $15 million in 2Q20 which added 5.0 cents to EPS. The tax rate dropped by 450bp in 3Q and generated 3.8 cents. Neither seems likely to be sustained.

Cash flow will likely have some headwinds as working capital is rebuilt. Releasing it has been a large part of recent cash flow:

XRAY Cash Flow	3Q20	2Q20	1Q20
Accts Rec.	-$119.6	$215.4	$53.3
Inventory	$74.8	$56.3	-$57.3
Prepaid Exp.	$17.2	$60.2	-$27.2
Other n/c assets	$2.1	$12.7	-$6.8
Accts Payable	$24.0	-$59.8	-$28.9
Accrued Liabilities	$66.0	-$43.5	-$95.1
Working Cap. Chg.	$64.5	$241.3	-$162.0
Cash from Ops	$207.1	$175.1	-$10.7

It is possible that 4Q and 2021 could see working capital consume more than $200 million in cash flow.

XRAY Cash Flow	3Qs 2020	2019	2018	2017
Working Cap. Chg.	$143.8	-$2.1	-$28.8	-132.5
Cash from Ops	$371.5	$632.8	$499.8	601.9
Capital Spending	$60.0	$122.9	$182.5	144.3
Acquisitions	$2.0	$3.2	$130.5	145.9
Free Cash Flow	$309.5	$506.7	$186.8	$311.7
Dividends	$65.9	$80.9	$78.6	$78.3
Share Repurchases	$140.0	$260.0	$250.2	$401

If working capital consumes cash going forward and we know XRAY already spent over $1 billion on another acquisition at the end of 2020, how much can it afford to spend on shares in the near future? Plus, capital spending has been low for two years already and should increase going forward. Also, if R&D increases back to 2018 levels, that will lower Cash from Operations too. This is not a dire situation overall, but it could slow the share buybacks. In 2020 so far, repurchases added 2-cents to adjusted EPS.

Inventory Levels Are Low and Could Help Sales Growth and Operating Leverage for Margins in Near Term

If we look at the inventory at XRAY and at the distributors – there should be some more demand coming for XRAY to fulfill pent-up demand and simply boost inventories available. This could be a tailwind for 4Q20 and even 1Q21 for XRAY sales:

XRAY DSIs	Dec	Sept	June	March
2020		115.0	176.4	143.4
2019	111.3	123.2	118.5	126.3
2018	102.2	135.6	124.3	143.8
2017	114.2	126.6	121.4	126.2

Sales falling in the 2Q20 certainly impacted the DSIs for inventory. The large reserves against inventory mentioned above also lower the DSIs. Arguably XRAY was in good shape starting 2020 on inventories and then COVID has lowered them further. That should enable the company to build what is most in demand and not suffer as much from inventory reserve accruals as in 2Q and 3Q. That should help near-term earnings.

For the distributors, we see the same thing. COVID had inventory levels out of whack based on lower sales earlier in 2020. However, now that business is correcting, the inventories may be too low. As we've noted in our past report on XRAY, when the channel is replenishing inventory levels – it tends to be positive for XRAY's gross margin:

Patterson DSIs	Dec	Sept	June	March
2020		56.0	64.4	74.7
2019	69.1	64.3	71.1	61.8
2018	70.3	65.2	73.3	64.1
2017	74.5	67.9	70.6	58.6

Henry Schein DSIs	Dec	Sept	June	March
2020		64.0	104.4	72.0
2019	70.2	71.1	74.3	77.7
2018	72.9	73.8	72.6	79.1
2017	73.0	66.4	64.4	70.6

And XRAY's adjusted gross margin has already bounced back:

XRAY adj Gross Marg.	Sept	June	March
2020	56.6%	42.1%	57.0%
2019	56.9%	57.7%	57.1%

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 Concern)- 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 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 upcoming quarters. 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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