BEHIND THE NUMBERS
Quality of Earnings Analysis

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Lamb Weston Holdings, Inc. (LW) 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 LW with a 5+ (Strong) rating.

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

Summary

Unlike most packaged food companies, LW has seen its sales and profits come under pressure due to the pandemic. While sales of its frozen potato products to retail customers have benefited from the surge in at-home dining, the bulk of its sales are to restaurants and commercial customers. Sales of french fries to customers with drive-throughs have held up reasonably well,

but lower sales to customers dependent on sit-down dining and non-commercial customers such as hospitals and schools have more than offset this.

Overall, we do not see any significant problems with the company's accounting quality. We applaud it for not resorting to non-GAAP disclosures with add-backs of arguably operational expenses. While it does report a significant portion of profits through joint ventures, its disclosure is reasonable. It has incurred higher inventory and production-related costs which should improve, but like most companies, the reversal of recent cost cuts such as advertising expenses and lower trade promotional activity will likely offset some of the improvement ahead.

What is weak?

- The company conducts a large degree of business via three 50% joint ventures with a total carrying value of approximately $290 million. It accounts for these under the equity method and reports profits on an after-tax basis as a line item on the income statement. Profits from these JVs typically run about 10-15% of total company net income. The company does a reasonable job of discussing factors impacting results at the JVs. Still, the lack of visibility into operating results is a negative for earnings quality.

- LW has a meaningful degree of interest rate risk as $602 million of its $2.8 billion in debt is variable-rate. The company disclosed in its 10-Q that a 1% increase in interest rates would negatively impact net profits by $4.7 million or a little over 3 cps.

- In the 5/19 quarter, LW identified a material weakness in its internal controls relating to how long temporary access was allowed to IT systems involved in financial reporting. There were no negative impacts reported and the matter was considered resolved by the end of the 5/20 quarter. While problems with internal control are always serious, we do not attach a high degree of concern to the matter.

What is strong?

- We appreciate that LW does not present non-GAAP results littered with "one-time" adjustments. There are no ongoing restructuring charges and write-offs that the company asks investors to excuse. This is remarkable, especially considering it was spun out of Conagra, a company that hardly ever reports a quarter without a significant charge.

- LW has made some minor acquisitions, but it is not the product of an ongoing roll-up strategy. Accordingly, goodwill and intangibles account for less than 10% of total assets which is unusual in the food industry.

What to watch

- Inventory days of sales have risen by 5-7 days in each of the last three quarters as demand from the company's full-service restaurant customers plummeted with COVID-related shutdowns. The increase in DSI was driven more by a decline in COGS than a rise in inventory. Inventory balances declined YOY in the 11/20 quarter. When viewed over a two-year period, inventory levels are not alarmingly high.

- In light of the decline in sales, the company elected to store the 2019 potato crop longer than normal as a way to manage inventory balances. This led to higher costs to process these older inventories due to storage costs, a lower yield, and the higher cost associated with processing older potatoes. These costs built up in inventory during the 8/20 quarter and were expensed in the 11/20 quarter, which contributed to the 310 bps decline in gross margin in the period. The company plans to process this year's crop in a normal time frame and does not anticipate these higher costs to continue.

- SG&A expense declined by about 20 bps as a percentage of sales after we adjusted out a $5 million expense related to the ERP rollout. However, the company received about 30 bps of tailwind from lower advertising expense which is likely to reverse as conditions normalize.

- While we applaud the company for not presenting its own non-GAAP results with endless charges added back in, this means that actual non-operating impacts such as one-time gains and losses are also included in the reported EPS numbers. This leaves it up to analysts to make their own adjustments. Adjustments that should be made every quarter include the mark-to-market impact of unrealized gains and losses on FX and commodity hedges which are reported both in the company's core operations as well as those reported under the joint ventures. Each of these sources regularly impacts EPS growth by 2-4 cps every quarter and should be taken into consideration when evaluating earnings beats and misses.

- LW emerged from the 2016 spin-off from Conagra with approximately $2.9 billion in debt which has remained fairly constant over time. This represents a little under 3 times net debt/EBITDA. This is on the high side, but the company regularly posts free cash flow after buyback north of $200 million annually. Also, it does not spend heavily on acquisitions to drive growth, does not spend heavily to buy back shares, and its dividend (1.3% yield) consumed only 40-50% of free cash flow before COVID.

Inventory Situation

The bulk of LW's inventory is made up of potatoes sourced via long-term and shorter annual contracts with growers. While COVID resulted in increased demand for the company's retail products sold to the at-home market through supermarkets, this was more than offset by the weakness in its sales to full-service restaurants. This resulted in LW reporting sales declines of 12.1%, 11.9%, and 15.6% in the 11/20, 8/20, and 5/20 quarters, respectively. In preparation for lower demand, the company delayed purchases of new raw materials and stored last year's supplies longer than usual to manage its inventory levels. The following table shows the calculation of days of sales (DSIs) for each component of inventory for the last twelve quarters:

	11/29/2020	8/30/2020	5/31/2020	2/23/2020
Cost of Products Sold	$672.600	$657.700	$735.800	$686.900
Total Inventory	$630.500	$470.600	$486.700	$597.300
Raw Materials and Packaging DSI	28.2	9.3	14.1	19.8
Finished Goods DSI	51.8	50.3	45.2	54.3
Supplies and Other DSI	5.4	5.6	5.5	5.0
Total DSI	85.3	65.1	64.8	79.1

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
Cost of Products Sold	$734.100	$740.400	$752.900	$653.400
Total Inventory	$636.000	$466.500	$498.300	$588.200
Raw Materials and Packaging DSI	26.5	7.3	11.3	21.7
Finished Goods DSI	47.9	45.8	44.9	55.5
Supplies and Other DSI	4.4	4.2	4.1	4.7
Total DSI	78.8	57.3	60.2	81.9

	11/25/2018	8/26/2018	5/27/2018	2/25/2018
Cost of Products Sold	$662.400	$684.300	$685.500	$621.100
Total Inventory	$628.200	$447.700	$549.700	$630.500
Raw Materials and Packaging DSI	30.1	6.5	11.6	
Finished Goods DSI	51.6	48.8	57.1	
Supplies and Other DSI	4.6	4.2	4.2	
Total DSI	86.3	59.5	73.0	92.4

While DSIs have risen YOY by 5-7 days in each of the last three quarters, they are not that out-of-line when compared to two years ago. Also, inventory levels declined YOY on an absolute basis in the 11/20 quarter with the DSI decline being driven by the greater decline in COGS. Therefore, we are not alarmed that the company has an unmanageable amount of inventory on hand.

We do note that the company incurred higher costs by storing last year's crop longer. There were higher than usual storage costs along with the fact that processing older potatoes yields less and costs more. This led to higher costs built into inventory during the 8/20 quarter which did not hit the income statement until the 11/20 quarter given the company's FIFO (first in-first out) inventory accounting method. This was a factor in the 310 bps decline in gross margin in the 11/20 period along with other unusual costs incurred due to COVID such as sanitation, safety protocols, and plant shutdown costs. Management identified $47 million of specific COVID-related costs in the 5/20 quarter and $16 million in the 8/20 quarter, but it did not add these back as non-GAAP adjustments. It also stated in the 11/20 quarter conference call that it would no longer quantify such costs as it was difficult to separate them from ongoing operating costs at this point, which we applaud.

Going forward, LW plans to process the current crop in a more normal time frame and it does not anticipate a repeat of the production inefficiency costs that plagued the 11/20 quarter. However, it has warned that it expects to continue to incur COVID related costs through the end of fiscal 2021 (the 5/21 quarter).

Lower Advertising Costs

LW tracks "product contribution margin" as a key indicator for core performance. This measure is calculated as sales less cost of sales and advertising and promotional expense. However, advertising and promotional expense is recorded under "selling, general and administrative expenses" on the income statement.

While the company incurred higher costs from COVID and related production inefficiencies, it was able to cut some costs to help offset this. Advertising was a notable area of savings. The following table shows advertising spend as a percentage of revenue for the last eight quarters:

	11/29/2020	8/30/2020	5/31/2020	2/23/2020
Advertising and Promotional Expense	$2.500	$1.200	$5.600	$6.600
% of Revenue	0.28%	0.14%	0.66%	0.70%

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
Advertising and Promotional Expense	$6.000	$4.800	$8.900	$11.000
% of Revenue	0.59%	0.49%	0.89%	1.19%

LW spends relatively little on advertising which makes sense given its high concentration of sales to restaurants and institutions. However, by more than halving advertising and promotional expense, the company was able to add a 30 bps tailwind to operating margins in the 11/20 quarter, a benefit that should turn to a headwind in upcoming quarters.

Despite the cuts, SG&A still increased by 40 bps as a percentage of revenue in the quarter. This was partly due to $5 million in spending on its IT upgrade project. Adjusting for this, SG&A expense would have fallen by about 20 bps as a percentage of sales. Again, kudos to the company for not automatically adding the IT expense back as a non-GAAP adjustment.

Decline in Trade Promotion Accruals

In addition to advertising, LW promotes its products with trade promotion deals which include slotting fees at retailers, cooperative marketing programs, and temporary price reductions conducted by the company's retail customers. The ultimate cost of much of these amounts will not be known until products are actually sold by customers. Therefore, the company estimates the eventual cost and records it as a reduction to revenue and an accrual of a liability at the time it sells the product to its customers. The following table shows a calculation of the accrued promotional liability relative to retail segment sales. While there may be some accruals related to the company's restaurant customers, we believe that most of the trade promotional accruals are related to activity conducted by the company's retail customers.

	11/29/2020	8/30/2020	5/31/2020	2/23/2020
Retail Sales	$140.7	$153.9	$201.9	$132.2
Accrued Trade Promotions	$36.6	$36.7	$42.5	$53.7
Days of Sales	23.7	21.7	20.6	37.0

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
Retail Sales	$132.1	$129.3	$129.2	$129.0
Accrued Trade Promotions	$54.3	$50.0	$48.6	$45.8
Days of Sales	37.4	35.2	34.2	32.3

Retail sales have been one of the bright spots in the company's operations as the pandemic has driven a surge in at-home dining. However, we can see that despite the increase in retail segment revenue, promotional accruals declined sharply sequentially in the 5/20 quarter and have remained depressed during the quarters impacted by the pandemic. This would ordinarily be a concern as it could indicate the company was inadequately accruing for promotional costs it would incur. However, in the current environment where its retail customers are struggling to keep the shelves stocked, we suspect the company was able to negotiate better terms for slotting fees and in-store promotional activity was not as necessary to drive sales in the unusual market conditions. This could have had a material benefit to sales and profit growth. For perspective, if accrued trade promotions had remained constant as a percentage of retail segment sales, it would have reduced total company sales and operating profits by over $20 million over the first nine months of the year. While we do not consider this aggressive accounting since there was a reasonable explanation for the decline, analysts must consider that this benefit will reverse as normal demand conditions return at the retail level. The reserve should rise by $20 million over time and every $5 million will hit EPS by about 3 cps.

Joint Ventures- Note Mark-to-Market Adjustments

LW maintains multiple joint ventures which include the following:

- 50% interest in Lamb-Weston/Meijer joint venture with Meijer Frozen Foods B.V. in the Netherlands which sells frozen potato products in Europe.
- 50% interest in Lamb-Weston/RDO Frozen, a potato processor in the US.
- 50% interest in Lamb Weston Alimentos Modernos S.A. joint venture with Sociedad Commercial del Plata in Argentina which sells frozen potato product in South America.

The combined carrying value of these three JVs was $291.4 million as of the end of the 11/20 quarter.

Results are accounted for under the equity method with after-tax profits shown on the income statement below the income tax line. The following table shows the after-tax profits of JVs relative to total company net income for the last eight quarters:

	11/29/2020	08/30/2020	05/31/2020	02/23/2020
T12 Net Income (Including JVs)	$296.000	$339.500	$365.900	$477.900
T12 After Tax Income from JVs	$34.800	$30.600	$29.300	$50.600
	11.8%	9.0%	8.0%	10.6%

	11/24/2019	08/25/2019	05/26/2019	02/24/2019
T12 Net Income (Including JVs)	$507.900	$491.500	$487.200	$479.600
T12 After Tax Income from JVs	$55.000	$50.200	$59.500	$69.400
	10.8%	10.2%	12.2%	14.5%

	11/25/2018	08/26/2018	05/27/2018	02/25/2018
T12 Net Income (Including JVs)	$497.800	$456.800	$433.700	$409.400
T12 After Tax Income from JVs	$81.600	$83.500	$83.600	$82.300
	16.4%	18.3%	19.3%	20.1%

Note that the decline in JV income in the 2019 periods was a result of the company acquiring the remaining 50% of the Lamb Weston BSW joint venture which resulted in the results of those operations no longer being reported with after-tax income from JVs.

Management does a reasonable job to discuss trends and operational factors in play at the JVs in its MD&A. We praised LW above for it not utilizing excessive non-GAAP earnings disclosures that can potentially distort the adjusted results in favor of the company. The downside of this is that it also does not include legitimate adjustments such as one-time gains or losses which leaves it to the analyst to look for such items in the commentary and footnotes. One source of such non-operational gains is the unrealized gains and losses associates with the mark-to-market impacts from currency and commodity hedging contracts in the JV's results which the company discloses in the "Equity Method Investment Earnings" section of the MD&A. Also, there was an unusual loss from the withdrawal from a multiemployer pension plan at one of the JVs in the 2/20 quarter.

The following table shows the impact of special factors affecting the reported results of the company's share of the JV results:

	11/29/2020	8/30/2020	5/31/2020	2/23/2020
GAAP After Tax Earnings from Joint Ventures	$19.200	$11.900	-$6.100	$9.800
Unrealized Gain/(Loss) from Mark-to-Market Adj.	-$0.100	$4.700	-$6.300	-$7.300
Loss Related to Multiemployer Pension Withdrawal	-	-	-	-$2.600
Adjusted After Tax Earnings from Joint Ventures	$19.300	$7.200	$0.200	$19.700
YOY Impact of Adjustments	$2.600	$3.600	-$3.700	-$6.400
EPS Impact	$0.014	$0.019	-$0.020	-$0.034

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
GAAP After Tax Earnings from Joint Ventures	$15.000	$10.600	$15.200	$14.200
Unrealized Gain/(Loss) from Mark-to-Market Adj.	-$2.700	$1.100	-$2.600	-$0.900
Loss Related to Multiemployer Pension Withdrawal	-	-	-	-
Adjusted After Tax Earnings from Joint Ventures	$17.700	$9.500	$17.800	$15.100

Over the last eight quarters, the EPS impact of the YOY effect of one-time items ranged from a 1.9 cps gain to a 3.4 cps loss. This is a source of non-operational gain that should be taken into consideration and matched to the earnings performance versus expectations to help determine the quality of the beat or miss in a given period.

Another item of explanation related to joint ventures is the company's agreement with Lamb-Weston/Meijer to share the cost of upgrading the company's ERP system. The JV footnote in the 10-Q for the 2/20 quarter states:

> *"During the thirteen weeks ended February 23, 2020, we entered into an agreement with Lamb-Weston/Meijer, effective as of December 31, 2018, to share the costs of a single, global enterprise resource planning ("ERP") platform and related software and services. Under the terms of the agreement, Lamb-Weston/Meijer will pay us in five equal annual payments, plus interest, beginning in the period the system is deployed at Lamb-Weston/Meijer. In connection with this agreement, we recorded a $6.0 million receivable from Lamb-Weston/Meijer in "Other assets" on our Consolidated Balance Sheet as of February 23, 2020. We expect the receivable to increase as development and implementation of the ERP progresses over the next year."*

The company also states in its MD&A section of the 5/20 10-K with regard to movement in SG&A expenses:

> *"SG&A expenses were $338.3 million, up $3.2 million, or 1%, in fiscal 2020 compared with fiscal 2019. The increase in SG&A was largely driven by approximately $11 million of net pandemic-related SG&A and other expenses described above, higher expenses related to our information technology services and infrastructure (including approximately $8 million of nonrecurring expenses,* ***excluding expenses payable to us by Lamb-***

***Weston/Meijer under the cost sharing agreement**, that primarily relates to consulting expenses associated with developing and implementing a new ERP system)…"*

LW books a receivable due from the JV as expenses related to the rollout of the ERP system are incurred. The receivable stood at $15.4 million as of the end of the 11/20 quarter and it will be paid when the system goes into service. The company's total spending on the EPR system is recorded in SG&A and the amount spent on behalf of the JV is offset by the booking of the receivable.

Mark-to-Market Adjustments in Other Segment Contribution Margin

In addition to unrealized gains and losses on FX and commodity hedges at JVs, the company records unrealized gains and losses in its core operations which it discloses in its segment disclosures under the "Other" segment results. The following table shows the unrealized losses at core operations for the last eight quarters:

	11/29/2020	8/30/2020	5/31/2020	2/23/2020
Mark to Market Gains/(Losses) in Other Segment Results	$4.300	$7.700	-$6.800	-$0.700
% of Sales	0.5%	0.9%	-0.8%	-0.1%
Impact from Change in Mark to Market Losses	$0.100	$4.600	-$0.900	-$7.300
EPS Impact from Change in Mark to Market Losses	$0.001	$0.025	-$0.005	-$0.039

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
Mark to Market Gains/(Losses) in Other Segment Results	$4.200	$3.100	-$5.900	$6.600
% of Sales	0.4%	0.3%	-0.6%	0.7%

We can see again that the unrealized gains and losses can be a source of 2-4 cps non-operational benefit or penalty to growth in a particular quarter. As with the similar amounts in JV results, these should be taken into consideration when assessing the quality of an earnings beat or miss in each quarter.

Identification of a Material Weakness

It is worth noting that in the 5/19 quarter, LW identified a material weakness in internal control related to its information technology involved in the financial reporting process. The flaw revolved around how long temporary access to the systems was allowed. No negative effects were reported and the company considered the matter resolved as of 5/20. This appears to be a

relatively minor matter and we do not attach a high degree of concern to the matter. For reference, below is the note from the 5/20 10-K discussion the matter:

> "As of May 26, 2019 the Company identified a material weakness in internal control over financial reporting related to ineffective information technology general controls (ITGCs) in the areas of user access over one of the Company's information technology (IT) systems that support the Company's financial reporting processes. Automated and manual business process controls that were dependent on the affected ITGCs were also deemed ineffective because they could have been adversely impacted. During a portion of the 53-week period ended May 31, 2020, the ITGCs were ineffective and the information or system generated reports produced by the affected financial reporting systems could not be relied upon without further testing.
>
> We identified the design and evaluation of the sufficiency of the incremental audit procedures over the financial information reliant on the impacted IT systems as a critical audit matter. Significant auditor judgment was required to design incremental audit procedures and assess the sufficiency of the procedures performed and evidence obtained due to ineffective controls and the complexity of the Company's IT environment.
>
> The primary procedures we performed to address this critical audit matter included the following. We used our judgment to determine the nature and extent of incremental audit procedures to be performed over the information produced by the impacted IT systems. We modified the types of procedures that were performed, which included testing the underlying records of selected transaction data obtained from the impacted IT systems to support the use of the information in the conduct of the audit. In addition, we evaluated the overall sufficiency of audit evidence obtained related to the information produced by the impacted IT systems.

Also from the 10-K:

> *As disclosed in Part II. Item 9A. Controls and Procedures in our Form 10-K for the fiscal year ended May 26, 2019, during the fourth quarter of fiscal 2019 we identified a material weakness in internal control related to information technology general controls in the area of application support team access to an information technology system ("IT System") that supports process controls and information used in our financial reporting processes. During fiscal 2020, management implemented our previously disclosed remediation plan that included enhancing our communication of internal control responsibilities to ensure the timely termination of access to the IT System when granted on a temporary basis to authorized members of our application support team. During the fourth quarter of fiscal 2020, we completed our testing of the operating effectiveness of the implemented controls*

and found them to be effective. As a result, we have concluded the material weakness has been remediated as of May 31, 2020.

International Business Machines Corporation (IBM)
Earnings Quality Update- 12/20 Qtr.

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

We are cutting our earnings quality rating on IBM to a 2- (Weak)

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

Summary

After steering investors to focus on revenue and cash flow instead of earnings, IBM promptly missed 4Q revenue targets with total sales down 6.5% with revenue down in every unit – not just global financing that is being wound down. They are also focusing investors on free cash flow as well where their adjusted figure was flat for 4Q at $6 billion and down $1 billion for the year at just under $11 billion. Working capital provided much of 4Q cash flow – primarily a nearly $1 billion increase in taxes payable that will be paid in 2021. We will likely need the 10-K to explore this quarter for more specifics on where $2 billion in charges was fully allocated. One item that jumped out was the spin-off/restructuring announced in October (4Q20) with the plan that it would cost $2.5 billion - $1.5 billion in cash (including taxes) and $1.0 billion non-cash. Now after 4Q20, the plan is already at $4.0 billion in cash costs expected with ~$3 billion in 2021. We also think the forecasts of restructuring to boost margins and grow revenues works out to produce about the same results as 2019 and even 2018 in terms of actual earnings.

What is strong?

- IBM is certainly not broke. Cash is about $14 billion and it continues to sell and wind-down financing receivables. Those declined by $4.9 billion in 2020 to $18 billion. It expects this cash on hand and further cash inflow from reducing those receivables to more than cover its $4 billion in restructuring/spin-off cash costs, its $6 billion dividend, and retire about $7 billion in debt. Plus, it will produce operating cash flow during the year. The issue arises longer term when the receivables no longer provide huge amounts

of annual cash flow and IBM continues to service a growing $6 billion dividend, its appetite for more acquisitions, capital spending of $3-4 billion, shareholders who like share repurchases, and about $54 billion in debt as it invests cost savings from restructuring into the business. Even IBM is only calling free cash flow of $12 billion – the dividend alone will consume half of that.

- IBM did see more spending in R&D in 2020, up $344 million or 6%. Also, we noted in 2019 that capital spending declined and it was up to $3.5 billion in 2020 from $2.9 billion. That is still below the level of spending in both 2017 and 2018 when IBM was a smaller company.

What is weak?

- It was reported on the call that IBM used a considerable amount of the $2 billion charge already taken to restructure contracts. This is the type of restructuring we find clouds the picture the most. If the contract was unfavorable to IBM, they had to entice the client to make a change: give them the equipment rather than rent it, cut their payments or write a check to convince them to change, etc. Then IBM can ignore that upfront cost as it's part of the restructuring and claim the profitability is now much better if they compare apples-to-oranges. Here is the CFO on the call,

  > *"We continue to take a disciplined approach to improving our margins and overall financial profile. As part of this,* ***a considerable portion of the $2 billion charge for structural actions was for GTS. We also have taken steps to restructure existing contracts and further reduce activity in lower value offerings****. These actions impacted our revenue performance this quarter but contributed to the gross margin expansion of 70 basis points. All of this positions NewCo for an improved margin, profit, and cash generation profile."*

  The CEO noted that customers have been promised more access to both companies in the future with their new contracts. We wonder if some of these future expenses for these enticements to change contacts were run through the $2 billion charge IBM took. We see that often when a company writes off fixed assets, but still uses them in the future and touts improved profitability. Right, there's no ongoing depreciation expense because it vanished in the restructuring charge. Here are the CEO's comments:

  > "*we have by and large gotten very positive feedback over 98% of them are quite satisfied with our description of what'll happen both in terms of their contracts, the service they'll get from us and the assured guarantee of access to technical resources, both from the new company and from IBM over time."*

- The changing size of the restructuring plan is also worrisome. Normally companies get past a few weeks before they suddenly expand a major restructuring plan. On October 8, 2020, the spin-off plan was expected to cost $1.5 billion in cash and $1.0 billion in non-cash charges and investors were told to expect a charge of $2.3 billion in 4Q. Now on January 21, 2021, IBM makes the following claim in its presentation, *"Adjusted FCF (of $11-$12 billion in 2021 and $12-13 billion in 2022)* ***excludes cash impacts from structural actions*** *and transaction costs associated with the separation of managed infrastructure services business;* ***Company expects ~$4 billion over 18 months with ~$3 billion in 2021."*** It sounds to us that the cash costs just rose to $4 billion.

- Falling ROI was one of our big concerns in looking at IBM's history. We noted in the original report that ROI used to be about 20%-22% before it started to become an acquisition machine and inflated the debt on the balance sheet. IBM made over 170 acquisitions – where much of the purchase price is recorded as goodwill, not amortized, and thus inflates operating income compared to what it would be if they built assets in-house. Even with that built-in inflationary impact on operating income, operating income was basically flat in 2017-18 compared to 2005 and down in 2019 and 2020. ROI was about 14% in 2019 and even adding back the $2 billion charge for 2020, ROI is now about 10%.

- Free cash flow for 4Q is reported as flat y/y at $6 billion, which excludes the impact of financing receivables that IBM has been selling and letting others run-off in a wind-down situation. However, 4Q20 had almost $1 billion in cash flow from a rise in taxes payable. IBM is warning of a $1 billion tax headwind for 2021 as part of the spin-off so that source of cash flow that makes 4Q20 look flat, appears very temporary.

- Is IBM actually predicting much growth at all? Listening to the earnings call – it was said over and over "we're going to grow sales and expand margins." Despite that, revenue fell across the various divisions, signings are down, backlog is down for units reporting it.

- IBM is guiding to Free Cash Flow of $11-12 billion in 2021 (excluding the restructuring) and $12-13 billion in 2022. That will be with all the new margin enhancements and growth potential well in-place. But, working backwards, IBM normally spends about $4 billion on Capital Spending and Software. So, they are looking for Cash from operations of $15-17 billion. Here are the main components of Cash Flow without working capital:

	2022 est	2021 est	2020	2019	2018
Net Income	$8-$9	$7-$8	$5.9	$9.4	$8.7
Depreciation/Amt	$7.0	$7.0	$6.7	$6.1	$4.5
Stock Comp.	1.0	1.0	0.9	0.7	0.5
Basic Cash from Ops	$16-$17	$15-$16	$13.5	$16.2	$13.7
Less CapX and S.W	$4.0	$4.0	$3.5	$2.9	$4.0
Free Cash Flow	$12-$13	$11-$12	$10.0	$13.3	$9.7

Looking at this more closely, IBM was earning $9 billion in 2018 and 2019. In 2020, we adjusted for the $2.0 billion charge and the $939 million tax benefit from transferring intangible assets to a foreign entity and just used a 12% tax rate to reach net income of $5.9 billion. The company's non-GAAP earnings largely add back amortization of acquired intangibles – the cash flow statement does that too so we used GAAP net income. This is a simplistic view of things focusing more on the big picture. The company cannot talk enough about Red Hat, it didn't own that in 2018 and had it for part of 2019. Yet the company appears to be guiding to flat income for 2021 and 2022 compared to those years with multiple years of growth for Red Hat.

- There are two wild cards for the company's guidance. Paying down more debt could provide a tailwind to earnings and cash flow. Currently, interest expense is just under $1.3 billion. Debt reduction may also be hindered if IBM continues to make several acquisitions. Also, working capital could be a positive or negative on cash flow. Normally, when a company is a growth mode – working capital consumes cash. IBM excludes the receivable run-off from the global financing in all its discussions about free cash flow, so that tailwind may help reduce debt, but should not be seen as a free cash flow generator from operations.

D.R. Horton Inc. (DHI) Earnings Quality Update-12/20 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 on DHI to a 5- (Strong).

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

Summary

We are reviewing the 10-K from DHI's fiscal 4Q that ends in September. It is difficult to find anything materially wrong with the company's recent results. Business and orders remain strong and arguably there is a bit of a perfect storm going on as COVID actually fueled stronger demand for homes while at the same time labor costs were not seeing upward pressure. We are upgrading our rating on DHI to a 5- reflecting little risk of inventory write-downs in the near future and improved liquidity. The minus sign indicates some common influences on EPS all working in DHI's favor of late that may be difficult to repeat at current levels.

What is strong?

- Liquidity remains very high for DHI with $3 billion in cash vs. $4.3 billion in debt. Cash flow remains strong even with higher working capital investments consuming cash. Should business growth slow, cash flow will likely increase as working capital is released.

- Often where builders start to run into problems is when they run out of cheap land. DHI does not appear to be in that situation. It has 376,900 lots owned or on option and 2020 as a huge year resulted in 78,458 homes closed. DHI has nearly 5 years of land inventory.

- Gross margin benefited more from declining building costs in 2020. Pricing was essentially flat. There may still be more time with minimal cost pressure from wages and materials.

- DHI has continued to ramp up its warranty reserves even though the pace of claims has not kept pace with the increase in home volumes. This may be a tailwind for EPS in the future in the range of 4-8 cents.

What is weak?

- DHI is firing on all cylinders at the moment. The concern we have is several areas may not be sustainable at this pace and turn from being earnings tailwinds to headwinds.

- Gross margin normally is impacted +/- 40bp by changes in pricing vs building costs. In 2020, DHI gained 150bp largely due to building costs declining y/y. That seems to be a COVID related benefit where higher unemployment pushed down wages and subcontractors wanting to lock in business at the worst of the panic. This generated 63-cents of the $6.41 in EPS. This benefit may wane in 2021.

- Inventory impairments still occur – but nothing close to the 2007-11 timeframe. DHI still has projects it walks away from and forfeits deposits. In other cases, there can be cost overruns or disputes. These have been running about 11-cents in EPS. In 2020, a strong year for earnings, these impairments were only 5-cents.

- DHI's tax rate in 2020 received a $93.4 million benefit from retroactively reinstating a federal tax item for 2018 and 2019. It also includes an $11.2 million valuation allowance release. The lower effective tax rate added 29-cents to 2020 EPS of $6.41.

- Share repurchases added another 12-cents to 2020 EPS via lower share count. DHI can afford to continue buying shares and also recently boosted its dividend. DHI remains a cyclical company and we're not sure it will get much long-term credit for repurchasing shares on the way up and adding 2%-3% to EPS growth that is already double-digit. Simply maintaining an exceptionally strong balance sheet or paying special dividends may be better uses for that cash.

What to watch

- Inflation is a risk that still looking benign at the moment. DHI admits they do not maintain large supplies of building materials on hand so those costs may change quickly. Also, the company largely hires subcontractors to do the construction. That may lead to faster wage inflation.

- Cancellation rates are not getting worse at this time. If those increase, it could leave DHI with more spec homes to sell and extend the time to complete subdivisions. That could lead to impairments.

Supporting Detail

Gross Margin Strength May Have Some Pressure Going Forward

DHI's business has been very strong with sales growth of late. It has seen volumes grow with COVID and for the most part, DHI picks up homebuilding revenues via volume growth not price increases. Modest price increases do happen in some markets, but others see declines.

Home Sales	f2020	f2019	f2018	f2017
Home Revenues	$19,560.8	$16,925.0	$15,502.0	$13,653.2
Growth y/y	15.6%	9.2%	13.3%	15.9%
Volume y/y	14.8%	9.9%	13.3%	13.5%
Price y/y	0.7%	-0.6%	0.2%	2.1%

Gross profit had a sizeable gain in several areas in fiscal 2020 too. Here are the following areas broken out:

Home Gross Profit	f2020	f2019	f2018	f2017
Gross Margin	21.8%	20.2%	21.3%	20.0%
Home Price Chg.	0.0%	-1.3%	0.6%	0.0%
Home Cost Chg.	-1.5%	0.0%	0.0%	0.0%
Purchase Acct Chg.	0.2%	-0.1%	0.0%	0.0%
Warranty & Defects	-0.2%	0.2%	0.4%	-0.5%
Capitalized Interest	0.1%	0.1%	0.3%	0.3%
Net Change y/y	1.6%	-1.1%	1.3%	-0.2%

- DHI reports home price change and cost of home change as a net figure. They call out the stronger part of it. So in fiscal 2020, falling home costs were the key to a 150bp boost in margin, while in fiscal 2019, falling home prices led to a 130bp drop in margin.

- Purchase Accounting changes relate to prior acquisitions and adjustments to fair market values placed on assets. This primarily deals with land acquired via the Forestar deal. Acquisitions remain a modest part of DHI's business model.

- Warranty and defects are spending to repair homes that have been delivered to customers.

- DHI capitalizes interest costs during construction of homes and that is added to homebuilding costs.

Looking at 2020: EPS was $6.41. Gross margin was 160bp higher than the year before. Driving this was primarily having a year when housing costs declined 150bp. This was likely helped by COVID to some degree creating more unemployment and make it easier to hire labor and materials may have seen some cost deflation too. DHI uses many subcontractors and they could have reduced their bids in late spring/early summer during the fear stages of COVID to lock-in some contracts. The company gained 63-cents from this margin source. DHI saw 8-cents of headwind from higher warranty and defect costs, but that was offset by the purchase accounting adjustments for 8-cents also. Lower interest costs added 4-cents as interest rates declined as well.

Looking at 2019: It also helped set up DHI's 2020 with an easy margin comp since pricing on homes declined 130bp. Of the $4.29 in EPS, this loss of pricing cost the company 44-cents in EPS. Lower warranty and defect costs helped by 7-cents in 2019 and the other items were a wash.

We think this is more a case of sustainability of results than a problem in earnings quality. When we looked back in time, we had to go to 2013 as the last time DHI was able to see net home price/cost rise as much as 2020 and in 2013 it was fueled but cutting sales incentives and pent-up demand after years of subpar volumes. DHI still has a strong backlog so we don't see signs that home volumes will drop by a large degree. We would just question if DHI will experience another year where it gains 150bp due largely to housing construction costs falling. In most years, the net +/- of pricing/cost changes is about 40bp. And don't forget, 2020 had a very easy comp of -130bp from 2019.

It is also possible that Warranty expense becomes a slight tailwind going forward. Despite having it be a small tailwind in 2018 and 2019, DHI continued to build the reserve as volumes grew. This also happened in 2020 when even settlements fell. We also noticed that warranty cost to boost the liability in pre-existing warranties is dropping. This normally has to do with DHI fixing some items that are off warranty but it sees it as building goodwill with customers:

Warranties	f2020	f2019	f2018	f2017
Starting Reserve	$247.3	$202.0	$143.7	$104.4
New Warranties	$114.4	$92.7	$81.6	$69.7
Chg. To Prior War.	$25.5	$32.0	$49.3	$30.0
Settlements	-$77.0	-$79.4	-$72.6	-$60.4
Ending Reserve	$310.2	$247.3	$202.0	$143.7

Inventory Impairments – Tailwind for Earnings May Not Last

Most investors fear the type of impairments that happen when housing demand is in decline. We currently do not see this risk as an imminent danger given the strength of the backlog and recent growth. This is still a cyclical business so the risk does remain. One of the biggest misunderstandings when it comes to impairments for a housing company is that the size of the write-off is limited to what is on the balance sheet as housing inventory or land/lot inventory. As we have discussed in the past, that is not true.

The exercise in determining impairments requires the company to estimate what its total future expenses will be to complete a housing project and the estimated cash flows and timing for when that will be received. The builder may have one-third of the project costs listed as inventory. However, the impairment will look at both the existing one-third already incurred PLUS the additional two-thirds that needs to be spent. If costs are coming in above forecast it can cause an impairment for the whole project as the expected net cash flow in vs. out will be lower.

What normally happens during a housing downturn is the expected cash inflow takes a hit. They have to discount prices, offer other incentives to move property, buyers walk away from homes under contract and the builder ends up owning more spec homes, and the time to sell all the properties may take longer. All that impacts the cash inflow estimates. The net result is a company may have say $100 million listed in inventory that is carried on an estimate it will earn a 20% margin. However, to complete the full project, the total spending required may be $400 million. With sales prices falling, extra costs, and added time to close out the project, the estimate may be that the revenue coming in may only be $370 million. Thus, the impairment is looked at as a $400 million cost, not $100 million, and those costs will not be recovered and take longer to close out. The impairment may be $150 million even though inventory is only listed at the moment at $100 million.

The company can often walk away from options on lots that have not begun construction. However, when dealing with full subdivision projects – they need to account that they may lose money on each unit and have several still to complete. Impairments of this magnitude have not been seen since 2007-09 with a decent impairment in 2011 as well.

What some do not realize is that impairments still happen in most years – but they tend to be much smaller. These can be projects there were contemplated but DHI walked away from and forfeited earnest money or deposits. There can also be isolated incidents of particular markets that may create a write-down. Some would basically call these types of impairments immaterial:

Impairments	f2020	f2019	f2018	f2017
Homebuilding	$1.7	$24.9	$10.9	$23.2
Earnest money forfeit	$21.2	$28.3	$13.4	$17.0
Disputed on land deal	$0.0	$0.0	$24.5	$0.0
Settlements	$22.9	$53.3	$58.8	$40.2
EPS Impairment	$0.05	$0.11	$0.11	$0.07
Total EPS	$6.41	$4.29	$3.81	$2.74

So, while impairments of the truly material amounts likely require some pricing erosion of new home values to occur and we don't see the signs of that now – can the impairment area show much more improvement for DHI this year? To us, it looks like a sustainability issue that will be difficult to maintain.

Share Repurchases Help EPS Growth – DHI has Cash Flow to Support It

DHI has helped EPS growth by buying back shares. Last year it added 12-cents to growth:

EPS Growth	f2020	f2019	f2018	f2017
# shares	370.2	377.4	383.4	378.9
Reported EPS	$6.41	$4.29	$3.81	$2.74
Growth	49.4%	12.6%	39.1%	16.1%
EPS from repos	$0.12	$0.07	-$0.04	-$0.03
Growth from repos	2.8%	1.8%	-1.5%	-1.3%

The growth rate in EPS has wide fluctuations since DHI is a cyclical company. We're not sure the money spent repurchasing shares has a meaningful impact here. It did just increase the dividend to 20-cents per quarter, which amounts to a 1.1% yield. In our view, a stronger case may be to focus more on higher dividends than repurchasing shares at current prices.

In DHI's defense, it has $3 billion in cash and only $4.3 billion in debt. It is not a serial acquisition machine either. Goodwill is $163 million against $12.1 billion in equity or just a tad over 1%. Because DHI uses subcontractors extensively for homebuilding, its capital spending needs are minor too. So looking strictly at free cash flow, paying for the dividend and repurchases is doable:

Cash Flow	f2020	f2019	f2018	f2017
CFO	$1,421.6	$892.1	$545.2	$440.2
CapX	$96.5	$127.2	$68.1	$102.7
Acquisitions	$9.7	$315.8	$159.2	$4.1
Free Cash Flow	$1,315.4	$449.1	$317.9	$333.4
Dividends	$256.0	$223.4	$188.4	$149.6
Repurchases	$360.4	$479.8	$127.5	$60.6

The two other things worth pointing out on cash flow is the inventory consists of land and houses so it is a hefty investment. As the company has grown, cash from operations is penalized by the rising working capital outlay. If business grows at a slower rate or declines, some of that working capital should be freed up. Also, DHI has some multi-family rental properties it has built and sold as well and that is also adding to cash flow:

Cash Flow	f2020	f2019	f2018	f2017
CFO	$1,421.6	$892.1	$545.2	$440.2
Working Capital	-$1,105.0	-$902.8	-$1,246.9	-$853.8
Adj. CFO pre W/C	$2,526.6	$1,794.9	$1,792.1	$1,294.0
Asset sales	-$60.5	$46.9	$222.7	-$54.6

Working capital increases are consuming about half the cash flow before that investment. So, the fact that DHI is still supporting its dividend (which will be about $295 million per year after the recent increase vs. $256 million in 2020), repurchases, and remains highly liquid is a big plus. It still seems unlikely that it will get much credit for buy back shares as the business is expanding, nor is it materially changing the EPS growth rate. We'd rather see DHI either pay special dividends or just bank the money with a fortress balance sheet to take advantage of cheap stock and assets the next time there is a down cycle for housing.

UnitedHealth Group Incorporated (UNH)
Earnings Quality Update- 12/20 Qtr.

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

We maintain our earnings quality rating on UHN of 5- (Strong)

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

Summary

UNH beat forecasts on adjusted EPS by 13-cents in 4Q20. We will need the 10-K to find some of the figures we are tracking to fully update 4Q results. UNH can probably beat guidance calling for 5%-8% EPS growth from $16.88 to $17.75-$18.25. As expected, the COVID earnings picked up in 1Q-3Q 2020 as patients deferred treatment, which held down medical costs and inflated earnings. Now that those treatments are back to normalized levels, UNH is expecting a $2 billion headwind for earnings as it compares to the 2020 quarters. At the same time, 2020 was penalized by the ACA tax that boosted its tax rate from 21% to 24%. That tax was repealed effective for January 1, 2021 – so that should lower the tax rate again. The tax issue should boost EPS by 69-cents in 2021 and the COVID headwind should reduce EPS by about $1.64 in EPS.

What is strong?

- The return toward normal operations was not as ugly on earnings as we anticipated. We believed premiums would be essentially flat with 1Q and 2Q, which happened. But we expected medical costs to balloon to the point where UNH may report flat earnings or even below the prior-year levels. It did not get that bad:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Med. Costs Payable	$21.9	$21.2	$19.2	$22.8	$21.7	$20.9
Quarterly Med Cost	$42.1	$41.6	$34.7	$41.0	$39.3	$39.0
DSP for Med. Costs	47.4	46.5	50.5	50.7	50.4	48.9
Premium Rev.	$50.6	$50.9	$49.4	$50.6	$47.6	$47.4
Medical Ratio	83.7%	81.7%	70.2%	81.0%	82.5%	82.4%
Premiums - Costs	$8.5	$9.3	$14.7	$9.6	$8.3	$8.4

This shows roughly flat premiums collected before, through, and after COVID. Quarterly medical costs dropped in 2Q20 allowing the net between revenue and cost to increase to $14.7 billion in 2Q vs. $8-$9 billion in other periods. We expected the deferred medical procedures to result in a higher increase in costs in 3Q and 4Q. It looks better than we anticipated. We thought the medical ratio of quarters medical cost to premium revenue could have jumped to the high 80% range. It looks like 3Q still benefited from deferred care. 1Q21 may see more headwind in this area. UNH noted that medical costs related to COVID were much higher in December which may carry over into January too. Every $0.1 billion that this source of earnings did not decline as deferred medical care was completed is about 8-cents in EPS. The beat was 13-cents in 4Q.

What is weak?

- Rebates are continuing to accrue but may still not be getting paid at past speed. This is a stat where we will need the 10-K to verify. UNH estimates the rebates and nets them against premium revenue – thus they are going through income as noncash earnings. However, the cash comes in on a lagging basis and is often tied to volume targets being reached – UNH simply cannot bill for the rebates as quickly as they go through earnings. The rebates go into "other A/R" on the balance sheet, which also includes Medicare D drug discounts. The "other A/R" account has been rising. It was $8.5-$10.0 billion before COVID. It was $13.2 billion after 3Q20. We do not know the 4Q figure yet. It is listed on the 4Q balance sheet as a catch-all of three working capital items. That catch-all was flat with 3Q20. Every $0.5 billion of increase in this area is just under 40-cents in EPS of non-cash earnings.

- UNH continues to repurchase stock with minimal impact on EPS growth. In 2018 and 2019, UNH spent $10 billion in cash to repurchase 41 million shares. But, during the same time, it issued 20 million shares via stock options. Thus, a $10 billion outlay produced only 2% incremental EPS growth in 2019. In 2020, the company spent $4.3 billion more on shares and added only 0.5% incremental EPS growth. Through 3-quarters of 2020, UNH issued more shares than it purchased. It looks like the heavy buying in 4Q

allowed the share count to drop by a minor amount. It is tough to make a case that shareholders are seeing much benefit from spending about 30%-35% of earnings on these repurchases every year.

What to watch

- We need to the 10-K to see what happened to medical cost estimates in 4Q20 and to see what the new sensitivity analysis for outcomes differing from estimates. This has been a continual source of incremental profits for UNH as the outcome has been favorable year after year. Through 3Qs in 2020, the same trend was being seen. This could be another source of 2%-5% of UNH's income.

- We also need the 10-K to see the current status of acquisitions and impairment analysis. In 2020, UNH spent another $7.1 billion on deals with $2.8 billion hitting in 4Q. We remain skeptical of UNH's accounting policies as much of the acquired assets are assigned to goodwill, which is not expensed. Goodwill is now $68 billion and 100% of equity. We had a problem with acquisitions made in 2019 and 2018 – which the company said had immaterial revenues and earnings – yet those deals are supporting $16 billion of intangible assets.

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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