BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Altria Group, Inc. (MO) 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 MO with a 3- (Minor Concern) rating.

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

We discontinue our SELL rating on MO and initiate earnings quality coverage with a 3- (Minor Concern) rating. We are moving all our buy/sell ratings to earnings quality coverage and will use our quarterly Focus List to communicate top long ideas and sell recommendations. Note that we do consider several areas of MO's recent year unsustainable.

Summary

MO missed EPS forecasts by 3-cents which surprised us as adjusted EPS declined by 2-cents. There was a 2-cent headwind from a higher tax rate and a 4-cent headwind from writing down residual values on equipment from PMCC. However, MO has had a perfect situation in our view with people switching from e-cigarettes back to regular cigarettes, plus they had more time to actually smoke given a lack of restrictions at home vs. work. Also, disposable income was helped by buying less gasoline, eating at home more, and restrictions on bars. MO had 9-cents in higher EPS from an increase in smokeable operating income in 4Q. We don't have a quarterly break-down but we know for the year, MO spent $37 million less on R&D and $7 million less on advertising in 2020 vs. 2019. That combined for 2-cents during the year.

The biggest positive for MO from customers shunning e-cigarettes and switching back to regular cigarettes is the e-cigarettes cost less and MO gets a 35% share of equity income when someone buys JUUL instead of 100% of a higher priced product in cash when they buy cigarettes. The same can be said of a very targeted roll-out of heated tobacco – where MO has to split some of the wealth with Philip Morris.

What is strong?

- COVID reversed the huge declines in cigarette volumes. Coming into 2021, MO was suffering from customers leaving for e-cigarettes, boosting the age of buying cigarettes to 21 (which cuts off future smokers), and growing restrictions on where people can smoke. Cigarette volume losses had been accelerating from 2% to 7% and MO was losing more than the industry. Suddenly COVID and JUUL problems saw people smoking more and switching back to cigarettes:

Y/Y Chg. Cig. Vol.	**4Q20**	**3Q20**	**2Q20**	**1Q20**	**4Q19**	**3Q19**	**2Q19**	**1Q19**
Altria	-1.0%	-1.0%	-2.0%	-3.5%	-6.0%	-7.0%	-7.0%	-7.0%
Industry	0.5%	1.0%	0.0%	-2.0%	-4.5%	-5.5%	-6.0%	-5.0%

  People going back to work, buying more gasoline, gasoline prices increasing, people spending more money in other areas, may cause a return to competition for disposable dollars and less personal time causing many to smoke less. In years past, MO has called out small changes in gas prices hurting volumes by 2%-3%.

- The stronger volumes mean the price hikes that MO takes every year didn't need to offset big drops in volumes. Thus operating income from smoking rose by $938 million in 2020 vs. $724 million in 2019. We think this continues to underline how dependent MO is on smoking. This is driving the cash flow:

Cash Flow	2020	2019	2018
Cash from Ops	$8,385	$7,837	$8,391
CapX	$231	$246	$238
Free Cash Flow	$8,154	$7,591	$8,153
Dividend	$6,290	$6,069	$5,415
Dividend Payout	77%	80%	66%
Repurchases	$0	$845	$1,673

$938 million in incremental smoking income is worth about $700 million net of tax. That's a sizeable gain in cash flow in 2020. A more normal year may see negative volume offset more than half that amount. Free cash flow is close to earnings before one-time items and MO is guiding to an 80% payout on the dividend in 2021 so some of the huge gain in 2020 may not repeat.

What is weak?

- Even management admits that cigarettes are a dying business and it plans to transition away into new areas. What else is working for them? Smoking products produced 85% of the operating companies adjusted income and oral tobacco has many downsides to health too is the other 15%. Volumes have been weak in for moist snuff too. MO is stocking the channel for the new *on!* dissolving tobacco by rolling it to many more stores. We think this cannibalizes snuff and the initial stocking growth will subside. We do not believe that consumer growth for any tobacco product is 27%. We saw the same situation with heated tobacco for Philp Morris in Japan and South Korea – huge growth as the channel was filled with inventory and then demand crashed as consumer sell-through became the actual source of demand.

- **There is no cash or declining cash from its equity investments. We are not certain what has to happen for MO's auditors to argue for an impairment in the ABI deal** – it's publicly traded so fair market value is easily determined without valuation assumptions. If one wants to look at ABI's valuation in the market – it's selling for 20x forward EPS with debt over 4x pre-COVID EBITDA. **We know that ABI has now written down its own goodwill in Africa in 2020.** The Africa market was a big part of the reason ABI bought SABMiller – which was MO's original investment. ABI has cut its dividend to MO twice at this point. Plus, by using the equity method to account for the deal, MO sees the value of its investment in ABI rise with its share of the earnings and the value falls with the ABI dividend. As the dividend gets smaller – it lowers the offset and the value of MO's investment can increase. Plus, this is not all COVID – the ABI investment owned by MO has been underwater since 2018. At the end of 2020, the difference between the fair market value of $13.8 billion and carrying value of $16.7 billion was $2.9 billion.

- Cronos is losing money in a huge way. Through September 2020, revenues of $29.7 million produced a gross profit of -$11.0 million after another inventory write-down of $11 million. Operating costs were another $110 million. **Cronos took a $40 million impairment to its goodwill and intangibles.** That's after the operating loss of $121 million. The only source of income at Cronos is marking the warrants MO holds to buy more shares to fair market value as the stock price changes. To MO's credit – it adjusts these marks to the warrants out of its non-GAAP EPS. But does Cronos sound like it's about to start paying large cash dividends to MO?

- We think the impairments at JUUL are widely known at this point. But we think investors should remember to the extent JUUL cannibalizes cigarettes – MO loses 100% cash income from the cigarette sale and gains a 35% share of JUUL's non-cash earnings. Also, MO now has 1,563 e-vaper lawsuits against it, up from 101 in 2019 and 2 in 2018. Does it sound like JUUL is about to start paying cash to MO? It does not to us.

- Looking at the cash flow table above, we think investors should note that share repurchases have essentially stopped at MO. The company issued more debt than it repaid in 2020 and is sitting on $5 billion in cash against $29.5 billion in debt. MO authorized a $2 billion repurchase plan, for 18 months. But we think investors who count on this form of payment to drive EPS growth and share repurchases should note that MO has a history of spending $1-3 billion on stock annually and has now gone two years with only $845 million. Nor does it appear that cash flow even with the surge in smoking income under COVID does not support a big repurchase plan. At the same time, dividend growth had been 8%-9% in many years – it's now 4%.

What to watch

- Do corporate tax rates rise within 1-2 years and reduce cash flow? We believed MO was headed for a dividend cut in 2017 before corporate tax rates dropped and boosted cash flow by about $1 billion annually. The company is already back to paying out 80% of free cash flow at this point. They have few tax shields with depreciation of only about $250 million and interest expense of $1.2 billion. We estimate that a 500bp increase in the tax rate would cut between $400-$500 million off of free cash flow. That's in addition to any pressures from volume decay in cigarettes resuming.

- There is more pressure again for the FDA to ban menthol. The FDA has already concluded that menthol makes it easier for people to start smoking and for them to smoke more frequently. It even concluded in studies that banning menthol would benefit public health. Attorneys General of 23 states have now petitioned the FDA to remove menthol from cigarettes and e-cigarettes as of January of this year. California banned menthol but enforcement is delayed until a ballot measure on the subject in November 2022. Menthol has been the area of tobacco where demand had held up better than other forms of cigarettes. We have highlighted in the past that several states and cities as well as other countries have banned menthol already (other countries do not impact MO – but could give the FDA more cover if they adopt a ban too.). If the bans come from larger states people may need a 5-6 hour round trip to visit an adjoining state where it is still legal to buy their cigarettes of choice. We think this is a potential game-changer to gap cigarette volumes down.

- The graphic health warnings for cigarette packages continue to move forward too with a court order that they now begin in January 2022. The FDA is in the second round of final submissions in this area that it expects to complete in March 2021. Again the use of graphic warnings has been ordered by courts at this point and are already widely in use around the world. Studies have shown that because cigarette packages are the one consumer product that smokers and non-smokers see many times per day and the graphic warnings have cut cigarette usage wherever they have gone into effect.

- In the case of the already in place 21-year age to buy tobacco nationwide, getting rid of flavored tobacco and e-cigarettes, some menthol bans already with more potentially coming, and graphic packaging – all of this has the ability to stop new smokers from even starting. When people see cigarette volumes fell 4% or 5% in a given year – that really means that perhaps 8%-9% of people quit smoking and were replaced by 4% new smokers for a net decline of 4%-5%. (We are just using these figures for an easy illustration). Many of these new rules are aimed at stopping new smokers. In our view, this could easily create a large gap down in cigarette volumes in the near future. MO looked well on this path and had COVID help in 2020. That may be a short-lived improvement.

Macquarie Infrastructure Corp. (MIC)- Maintain BUY

We are keeping our BUY rating on MIC and not initiating EQ coverage as the company is in the process of selling itself.

Summary

Following 4Q20 results, MIC noted progress on its process to sell the company and return capital to investors. It is worth noting that Signature Aviation was sold for 16x 2019's EBITDA. That business is very similar to MIC's Atlantic Aviation unit, which is now seeing activity return and it continues to invest in future growth for the business. EBITDA pre-COVID was $276 million and finished 2020 at $195 million, but has improved significantly since the travel shut-downs:

Atlantic Aviation EBITDA	4Q	3Q	2Q	1Q
2020	$58	$54	$17	$66
2019	$71	$64	$62	$79

Guidance for Atlantic Aviation is $220-$240 million in EBITDA for 2021 as the business recovers. We think the business should be worth $3.85 billion based on 16x the $240 million figure or $4.4 billion based on 16x the $276 million figure from pre-COVID. Atlantic has expanded operations since 2019 and continues to add hanger space now.

The sum of the parts looks like this:

Sum of the Parts	A.A. at $240	A.A at $276
IMTT sale net of debt	$989.0	$989.0
Atlantic Sale at 16x EBITDA - debt	$2,836.0	$3,412.0
MIC Hawaii at 10x EBITDA - debt - 21% tax	$321.0	$321.0
Total Proceeds	$4,146.0	$4,722.0
Management Fee	$207.0	$289.0
Net to Shareholders	$3,939.0	$4,433.0
Value per share	$45.1	$50.7
less $11 already received from IMTT	$11.0	$11.0
Remaining Value per share	**$34.1**	**$39.7**
Cash on hand after bond tender	$330.0	$330.0
Expected 2021 free cash flow	$130.0	$160.0
Potential extra cash per share	**$5.3**	**$5.6**

- There is a management bonus based on the level of sales proceeds received. The sales proceeds are net of debt, transaction costs, and taxes owed. The bonus requires the sales process be completed in 2021 so much of this could be known before year-end. The bonus is a sliding scale of 2.91%-6.10% of net proceeds.

- Atlantic Aviation has $1.0 billion in debt that would be netted against any sales proceeds and MIC Hawaii the gas utility has $194 million in debt.

- As described below, the goal is to structure a deal that will not incur capital gains taxes on Atlantic Aviation, but would result in taxes on a transfer of MIC Hawaii. We simply assumed 21% of the total net proceeds. The gain is likely smaller than that.

- IMTT was already sold net of its debt. MIC retained cash to retire the corporate level debt and it has now tendered for the bonds. The proceeds net of all debt was about $989 million. Shareholders were paid $11/share or just over $961 million already with $28 million accrued for management bonus.

- Per the CFO on the 4Q20 call this week, MIC has $330 million in cash after paying taxes and fees from the IMTT sale and what will be spent retiring the debt in the tender offer. Also, the company expects to report Free Cash Flow of $130-$160 million from Atlantic Aviation and Mic Hawaii this year. That cash would either reduce the net debt for either business upon sale or would be left over at MIC and distributed to shareholders. This may result in an extra $4-5 per share at the end of this process.

- We estimate MIC's remaining assets being worth $38-$44 per share at this point against the current value of $31 to $32 – above $35, we'd probably not be looking at this as a BUY.

What to watch

- MIC believes that the Hawaiian gas company can be sold, but it will require approval of the public utility commission as well which should require a longer closing period. That is likely going to result in this being the last asset sold. However, if they they sell Atlantic Aviation first, there would be a capital gain tax to pay on the Atlantic sale.

- MIC plans to change its structure to an LLC. The LCC will need shareholder approval and could see a vote in May 2021. However, MIC will delay the actual change to an LLC until they have a deal to sell Atlantic. That will result in a short time of shareholders owning an LLC.

- The Hawaiian gas unit will be migrated up to MIC the LLC – that will be a taxable event. Given the much smaller size, it should be a lower tax bill. That would allow Atlantic to be sold without a capital gains issue and the proceeds distributed to owners of MIC. Selling the remaining LLC that would own MIC Hawaii would be the final step.

- The tender offer for the MIC bonds should be complete within one month, that should also reflect some progress in the necessary unwinding of the full structure.

MOWI ASA (MHGVY) Earnings Quality Review/Update

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 MHGVY with a 4+ (Acceptable) rating.

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

We discontinue our BUY rating on MOWI and initiate earnings quality coverage with a 4+ (Acceptable) rating. We are moving all our buy/sell ratings to earnings quality coverage and will use our quarterly Focus List to communicate top long ideas and sell recommendations. Note that we do see more upside for MOWI with its new dividend policy and salmon pricing firming along with strong demand. 2021 looks like a solid year may be at hand.

Summary

MOWI's moving parts of harvest volume, fish pricing, and FX can create lumpy results, but trends appear to be moving in the right direction. For much of the quarter, weak sales to China hurt results by keeping high supply in other parts of the world and holding down pricing. What is key is by the end of 4Q, pricing recovered significantly and even the CEO noted on the call discussing results, *"Cost was down year-over-year, and volumes were up. So then the only missing factor in the equation is prices,"* as he pointed to pricing in the US at 2019 levels at the end of the quarter and even Norwegian prices had bounced up by more than one-third. He further noted that the China export issues appear to be resolved too. *"Consumption in China was impacted by uncertainties regarding import certificates, which should now, for the most part, be solved, and also confidence issues in imported food in general. But we see now that volumes are improving."*

We are pleased to see MOWI's confidence that 2020's COVID problems should be behind them as they reinstated the dividend at 50% of reported EPS and made that their policy going forward. It also guided to slightly higher harvest volume in 2021 and expects to see working capital investment increase due to higher salmon pricing. MOWI also saw their biomass inventory adjustment marked up in 3Q due to more fish in the pens and marked up again in 4Q due to improved pricing. That is a big swing from 1Q and 2Q.

The 4+ rating is based on MOWI still having a sizeable income statement and balance sheet item that tracks the value of live fish based on a number of management assumptions on future pricing, future costs, and mortality. Also, results are very lumpy even though MOWI has reduced costs and going to vertical integration further helps the situation. The movement in salmon pricing remains a powerful indication of results and assumptions on biomass.

What is strong?

- Guidance for 445,000 of salmon harvested in 2021 is only 1.2% more volume than 2020. However, in 2020, pricing in Euros was largely between €4-5 per kg from mid-March. Historically, pricing is above €6 per kg. Adding €1 per kg, would almost double EBITDA in 2020 from €505 million to over €900 million. MOWI is feeling so strongly about pricing in 2021 that it locked in a lower percentage of contract sales. According to the CEO on the 4Q call, *"Then over to contracts. As you can see from the graph here***, we are at the low end of our contract share policy, and that's deliberately. It's on purpose. We believe in a market recovery.** *And therefore, we have decided to be light on contract."* For contracts from Norway, MOWI has about 15,000 tons contracted in 1Q and 16,000 tons in 2Q, vs. about 22,000 and 24,000 in the same periods of 2020. See Supply Forecast below under What to Watch?

- Cost-cutting is also evident. MOWI has been investing in more automation to reduce employees, improved its procurement programs, and has worked to lower biologic expenses. In 2020, it cut €35 million in costs like these and is targeting €25 million more in 2021. Even on higher volumes, its feed costs were basically flat or rose less than volumes in some regions. Lower price accounts for more than 100% of the drop in income for 4Q: EBIT down €116 million, pricing at farming was down €145 million. For 3Q, EBIT fell €67 million with pricing down about €84 million. We believe income can grow even faster given the lower cost base being leveraged by higher prices.

- **Free cash flow for 2020 was €187 million. Just on guidance for cash costs, 2021 free cash flow should rise by €76 million.** (For 2021, MOWI is forecasting CapEx to fall by €50 million, interest expense by €18 million, and taxes by €58 million, while working capital should rise by €50 million.) As noted after 2Q, **MOWI was looking to sell its stake in DESS and did so in 1Q21, which will boost cash flow by €114 million.** There was already €100 million in unrestricted cash on hand. A rise in salmon prices should further add to cash flow as noted above. It appears that cash and liquidity should rise noticeably in 2021.

- The dividend returned. Historically, MOWI paid a significant dividend > 6% as part of its way to reward shareholders. During COVID, the dividend was suspended to retain liquidity and also due to the disruptions in the normal pricing model and ability to sell into other foreign markets. MOWI announced a dividend based on 4Q EPS of 0.32 NOK.

  - The new dividend will be to pay 50% of underlying EPS as a dividend. Underlying EPS is EBIT less interest less taxes without accounting for new operating lease impacts on earnings.
  - When the company's debt is at €1.4 billion or below, it will consider paying additional extraordinary dividends or repurchasing stock as well.
  - Additional payments will likely also require a favorable outlook for future cash flows and future cash needs.
  - The payment of 0.32 NOK is only 4-cents per share in USD. It is worth remembering that under better salmon pricing scenarios, MOWI was paying essentially 30-cents per share or $1.20 in annual dividend in USD (it moved based on the NOK to USD exchange rate).

- Consumer Products continue to expand. We have noted that MOWI's goal is to get the US market to per capita levels of Germany in terms of people eating salmon products. The big roll-out was expected in 2020, but COVID delayed that. Consumer products continued to grow for MOWI even with COVID as many people bought salmon in grocery stores during lockdowns.

Consumer EBIT in €	**4Q**	**3Q**	**2Q**	**1Q**
2020	34.8	21.2	23.3	2.4
2019	17.3	13.8	7.5	6.8
Europe EBIT				
2020	21.9	8.1	11.0	-7.4
2019	10.1	5.0	1.1	1.6

  - Europe is the more established market and suffered early in COVID because flight restrictions stopped product from getting to Asia and a glut of salmon hit Europe early on. Asia saw declines in consumer EBIT from 1Q-3Q, and rose in 4Q
  - America saw higher consumer business in all four quarters and posted stronger margins.

When MOWI rolled out consumer products in Germany, per capita consumption was 1.1kg annually. That rose to 2.1g in eight years. The US is a much larger market and starting at 1.2kg per year now. What happens is people not only buy more salmon products in the store, they eat more salmon in other places too. We still see this as a big source of future growth for MOWI.

What is weak?

- The Canadian operations will see much of the western operations close due to Canadian government policy changes. This will cost MOWI about 10,000-12,000 tons of harvest volume. That is built into the forecast for 445,000 tons. This will emphasize production in Eastern Canada, which MOWI considers the toughest place to farm:

  > *"Bear in mind, we bought this [Canadian operation] back in 2018. It's not a long time ago, and then we run into a severe mass mortality from an algae bloom. Last year was also challenging. We had not a mass mortality, but we struggled with plankton. Lice is also an issue in the East.* ***They have a very warm summer and a very cold winter, so you could say the worst of 2 worlds. That makes it even more challenging to be a farmer. So of all spots on the planet, I think, where you actually can do this, let me underpin that. I think Canada East is one of the most challenging areas. So it's much tougher to deliver results in this area than in other areas.****"*

  There will be a €6.1 million charge in 2021 to restructure the Canadian operation and decommission operations on the west coast of Canada. The goal is to lower costs and grow Canada back going forward. This will be about 7% of MOWI's production. MOWI has improved health issues in other regions, but it sounds like this may remain a very lumpy source of profits/losses going forward.

- Foreign Exchange remains a wild card for MOWI. There are two primary exchanges to watch – NOK to USD. The stock trades in NOK and thus the ADR in the US is impacted by the exchange rate. Norway is an oil country so its currency tends to move up or down with oil prices. The exchange rate is currently 8.5 NOK to the dollar. That has improved considerably from early COVID and $13 oil when the NOK was almost 12 to the dollar and has fueled some of the stock price gain in 2020. Historically, the NOK trades closer to 5-to-1 but that has been a long time. So this may not be the same type of tailwind going forward.

  MOWI's operations are reported in Euros. So there are some FX issues of the Euro vs the USD and Asian currencies for sales. The larger issue is much of the farmed salmon in the world comes from Norway. Many competitors report their feed costs in NOK and as the NOK depreciated, they effectively had lower feed costs and thus lower cost salmon and could afford the lower salmon prices better than MOWI in 2020. Going forward, those competitors would see future feed costs effectively rise faster and they will give back those incremental 2020 profits. The NOK/Euro relationship is returning to normal levels now. MOWI should see competitors needing better pricing in 2021 and help boost overall pricing too and MOWI does not have the feed cost headwind from FX.

What to watch

- Supply and Demand were largely in balance for 4Q. Chile on supply and China on demand were the wildcards last year. If China was merely flat in 4Q and 3Q, demand would have exceeded supply the last two quarters and likely spurred better prices before late 2020.

Market Balance	4Q	3Q	2Q	1Q
Supply Growth	10.8%	4.8%	3.3%	2.3%
Demand Growth	10.0%	4.8%	1.3%	0.4%
Chile Supply	20.4%	15.6%	9.7%	8.6%
China Demand	-48.5%	-51.5%	6.9%	-29.8%
y/y Demand with flat China	11.2%	7.1%	0.9%	2.0%

  - China had been about 5% of world demand and dropped to 2% in much of 2020. Early on, this was a lack of air travel making salmon shipping difficult. Later in the year, it was more paperwork and certificates to get salmon into China.
  - **MOWI's CEO says much of the certificate issues are behind them now. If China demand can now return toward more normal levels, it should absorb considerable supply.** This was the difference in 3Q and 4Q of having demand exceed supply growth and having it equal to or below supply growth. That would help pricing.
  - **Chile is about 28% of the world supply and rose 20% in 4Q, but that was only up 1% in December. Looking at salmon going from Chile to Miami in 4Q, the prices rose from $3 to over $5 per pound as Chile supply fell.**
  - More importantly, the biomass in Chile fell 12% y/y at the end of 4Q. Forecasts have Chile supply falling by 10%-15% vs 2020 levels in 2021. Total world supply is forecast to rise only 0%-4% in 2021.

- Foodservice continues to hurt salmon demand. Even with the growth in consumer products and people eating more salmon at home, that is not offsetting the closure and restrictions on restaurants. MOWI still estimates this as a net loss of demand of about 5%. As the world gets past COVID, MOWI should see a growing foodservice business and consumer products business and recapture the sales lost from food service in 2020. In some quarters of 2020, MOWI was estimating the net loss as about 10% of sales.

TreeHouse Foods, Inc. (THS) 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 maintaining our earnings quality rating of THS at 3- (Minor Concern)

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

Summary

THS hit forecasts for 4Q20 of $1.07. It gained 3-cents in the Riviana acquisition as THS marked up the value of the acquired inventory by $3.1 million, and then expensed $2.1 million of that mark-up in 4Q20. On adjusted results, they added back the $2.1 million. THS also reversed a $6.2 million tax valuation allowance into earnings for 2020. That added 12-cents to EPS, it's just not clear if all of it hit in 4Q.

The company guided to more restocking of the channel in the quarter and that is what happened. Volume growth that practically disappeared in 3Q with COVID demand normalizing – rose from $4.2 million to $40.3 million in 4Q. Every $10 million of sales that is likely one-time in nature added over 1-cent to EPS. As we noted after 3Q, we think THS had the shortest-lived COVID bump of the various food companies we follow:

Organic Growth	**4Q20**	**3Q20**	**2Q20**	**1Q20**
Volume	$40.3	$4.2	$38.7	$32.3
Price	$4.8	$2.7	-$1.7	-$5.5
Organic Growth	$45.1	$6.9	$37.0	$26.8
Growth rate	3.9%	0.7%	3.6%	2.6%

That weak growth came against negative comps of -4% to -6% in 2019. Guidance is for sales of $4.4-$4.6 billion after hitting $4.4 billion in 2020 with COVID. And most importantly, the Riviana deal that closed in December is expected to add $170-$180 million in sales. Adjusted EPS for 2020 was $2.73 and THS sees Riviana adding 20-30 cents to 2021's total and expects

EPS of $2.80-$3.20. This guidance also seems to rely on taking pricing to offset higher freight, employee, and raw material costs. THS is saying they hope to see some higher pricing help by the 2H21, but they have not been able to take much pricing. In 2018, they had pricing 1.4%, then 0.6% in 2019, and 0.0% in 2020.

What is weak?

- We still consider gross margin growth to be amazingly poor. Keep in mind, THS has been culling lower margin SKUs for years now. For a company with $4.4 billion in sales, it removed over $600 million in SKUs from 2018-2020. That should have helped gross margin. Also in 2020, COVID meant smaller restaurant sales, which are lower margin too and THS replaced that with higher margin sales to retailers. Yet, adjusted gross margin is still lower than when this all started. In 4Q, adjusted gross margin was up only 11bp y/y. We think that indicates huge pressure from retailers to reduce their costs and pushing on THS's margins:

	2020	**2019**	**2018**	**2017**
Adj. Gross Margin	19.7%	19.1%	20.0%	21.2%

  Going forward, lower margin restaurant sales should return and retailers won't need as much inventory stocking and they can push back more. As noted in the summary, THS is planning to boost prices in 2021 and have those kick in for the second half of the year. Pricing gains were only 1.4% in 2018, 0.6% in 2019, and 0.0% for 2020.

  It is also worth considering that THS's own inventory has been rebuilt at this point. DSI's were 58.5 days in 4Q20, which compares well with 54.3 days the year before and 59.6 days after 4Q19. To the extent that rebuilding its own inventories from Qs 1-3 in 2020 helped it leverage some fixed costs and boost margin – that tailwind may be gone too.

- THS is not seeing margin gains from cutting Selling & Distribution costs or G&A costs. Thus, its growth relies on gross margin gains holding and as noted in the prior section, 2020's gross margin improvement looks short-lived.

Adj. Other Costs	**4Q20**	**3Q20**	**2Q20**	**1Q20**	**4Q19**	**3Q19**	**2Q19**	**1Q19**
Selling & Dist.	$73.5	$59.8	$62.7	$64.4	$64.1	$60.0	$59.8	$70.2
% of Sales	6.2%	5.7%	6.0%	5.9%	5.6%	5.7%	5.8%	6.6%
G&A costs	$53.5	$50.1	$61.9	$63.0	$50.1	$50.9	$59.4	$60.6
% of Sales	4.5%	4.8%	5.9%	5.8%	4.4%	4.8%	5.8%	5.7%

THS is already saying it expects $100-$110 million in raw material cost headwinds to impact gross margin in 2021. It also noted that freight and employee wages are rising too which should hit distribution and G&A costs too. We are also going to note that THS cut R&D costs again in 2020 – down to $16.6 million from $18.8 million in 2019. And its marketing allowance remains very low at $39.6 million but used to be almost $57 million. COVID allowed many companies to cut marketing – but going forward those costs may return.

- THS did come in light on capital spending. Forecasts for $135 million for 2020 only hit $106 million. Forecasts are for $140 million of spending in 2021 so this is a cash flow headwind going forward.

- The Riviana deal is broken out. Of the $239 million spent, 24% will be allocated to goodwill and not amortized. 28% will be allocated to customer relationships and amortized over a whopping 20 years. As an aside – shouldn't investors believe that THS already had relationships with some of the same retailers? Tradenames are 18% of the allocated price and will also be amortized over 20 years. Inventory was a mere 8% and PP&E only 20%. It is worth noting that THS marked up the inventory by $3.1 million and then expensed $2.1 million in 4Q20 but then added back that expense to adjusted EPS. That was worth 3-cents in EPS.

- Some cash flow headwinds for 2021 still remain.

    - THS continued to sell receivables and slow its payment to the banks as it collected the funds. This facility allows a max $300 million of receivables to be sold and it was at $284 million in 4Q. Plus, the amount of money collected but not sent to the banks was $203 million – that is the highest we have seen it and it produces cashflow for THS:

	4Q20	**3Q20**	**2Q20**	**1Q20**	**4Q19**	**3Q19**	**2Q19**	**1Q19**
A/R Sold	$284.3	$226.7	$200.1	$229.8	$243.0	$196.2	$184.5	$148.7
Payables on Collections	$202.8	$123.6	$131.3	$106.7	$158.3	$136.6	$70.5	$97.5

- We also noted that THS benefited by claiming a tax refund of $71.4 million in the 4Q and intends to file for another $14.1 million refund on 2020 taxes for 2021.
- THS will need to deal with repaying the CARES Act payroll deferrals in 2021 and 2022 – about a $10-$12 million headwind in each year.
- It also sounds that if raw material costs increase – inventories could consume cash in 2021.

Ball Corp. (BLL) 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 maintaining our earnings quality rating of 3- (Minor Concern)

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

Summary

Our review of the 10-K did not turn up any new earnings quality concerns. Our concern remains focused on the quality and sustainability of cash flow growth.

What deteriorated?

- Outstanding factored receivables rose by $52 million from the 9/20 quarter to the 12/20 quarter versus a $25 million increase in the comparable year-ago period. This implies a roughly $27 million incremental boost to cash flow growth in the quarter from increased factoring. The sequential increase in factoring is slowing and we remain concerned that the sizeable tailwind to cash flow growth it has provided will fade or even reverse. We are skeptical the company can reignite it given the balance of outstanding factored receivables exceeds receivables left on the balance sheet.

What to watch

- Depreciation expense rebounded from the 9/20 level to more in-line with recent trends. However, depreciation as a percentage of gross PPE has declined as the rising Construction in Progress component has yet to be depreciated. If we apply a historical deprecation percentage to the current gross PPE balance, depreciation expense would have been more than 5 cps higher than reported. Investors should remember this cost will hit the income statement as the new capacity is brought online.

Supporting Detail

Receivables Factoring Slows Sequentially

We have been tracking the rise in the company's use of its receivables factoring program for the last few quarters. In our review of the third quarter, we noted a sharp sequential YOY and sequential jump in factored but outstanding balances. In the fourth quarter, the sequential increase decelerated but outstanding factored balances are significantly higher than a year ago. The following table shows the calculation of balance sheet DSOs, factored DSOs, and total adjusted DSOs for the last eight quarters:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Sales	$3,102	$3,093	$2,801	$2,785
Net Trade + Unbilled	$1,344	$1,418	$1,447	$1,417
DSO	**39.9**	**42.2**	**47.0**	**46.3**
Outstanding Factored Receivables	$1,368	$1,316	$1,073	$1,098
Factored DSO	**40.6**	**39.1**	**34.9**	**35.9**
Adjusted Receivables	$2,712	$2,734	$2,520	$2,515
Adjusted DSO	80.4	81.3	81.9	82.2

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Sales	$2,719	$2,953	$3,017	$2,785
Net Trade + Unbilled	$1,186	$1,405	$1,511	$1,426
DSO	40.1	43.8	45.6	46.1
Outstanding Sold Receivables	$1,170	$1,145	$1,092	$1,008
Factored DSO	39.6	35.7	32.9	32.6
Adjusted Receivables	$2,356	$2,550	$2,603	$2,434
Adjusted DSO	79.7	79.4	78.5	78.7

We can see that total adjusted DSOs rose from 79.7 in the 12/20 quarter to 80.4 in the 12/20 quarter, so the company has not become much more aggressive in extending payment terms. Factored receivable days rose by 1 YOY and were up almost 1 sequentially. Factored receivables rose by $52 million from the 9/20 quarter to the 12/20 quarter compared to a $25 million increase in the comparable year-ago period. This implies that growth in cash from operations could have boosted by roughly the difference of $27 million. The artificial benefit to cash flow growth from accelerated factoring is waning and we are skeptical that it can be reignited given that outstanding factored receivables now exceed the total of trade receivables ($825 million at 12/20) and unbilled receivables ($528 million at 12/20) that are left on the balance sheet. This could lead to disappointing cash flow growth which could be a problem as the company looks to continue its aggressive capex plan over the next couple of years.

Depreciation Down Despite Rising PPE- But This Will Reverse

We noted an unusual decline in depreciation expense in our review of the 9/20 quarter. While depreciation expense rebounded in the 12/20 quarter, it remains even with the year-ago level despite a noticeable increase in PPE from the company's capital spending program. The company offers excellent disclosure on PPE, providing the gross components on a quarterly basis. This information is shown in the following table along with a calculation of depreciation expense as a percentage of average gross PPE for the last six quarters:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Land	$163	$160	$153	$151	$153	$148
Buildings	$1,653	$1,533	$1,466	$1,425	$1,433	$1,352
Machinery and Equipment	$6,214	$5,869	$5,696	$5,467	$5,513	$5,203
Construction in Progress	$883	$734	$626	$591	$434	$508
Gross PPE	$8,913	$8,296	$7,941	$7,634	$7,533	$7,211
Accumulated Dep.	$3,562	$3,401	$3,279	$3,135	$3,063	$2,891
Net PPE	$5,351	$4,895	$4,662	$4,499	$4,470	$4,320
Quarterly Depreciation Expense	$123	$115	$126	$124	$123	$123
Depreciation % of Gross PPE	1.4%	1.4%	1.6%	1.6%	1.6%	1.7%

We are still unsure why depreciation dipped in the 9/30 quarter. Nevertheless, we see that despite the material increase in gross PPE, depreciation has remained flat with historical levels. This would ordinarily be a red flag signaling an aggressive increase in average deprecation periods. However, the following table which shows the PPE components as a percentage of gross PPE gives us more insight into the cause:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Land	1.8%	1.9%	1.9%	2.0%
Buildings	18.5%	18.5%	18.5%	18.7%
Machinery and Equipment	69.7%	70.7%	71.7%	71.6%
Construction in Progress	9.9%	8.8%	7.9%	7.7%
Gross PPE	100.0%	100.0%	100.0%	100.0%

Despite the significant increase in Machinery and Equipment, which is depreciated over 2-20 years versus 5-40 for building and improvements, Construction in Progress, which is not depreciated until placed in service, has increased more as a percentage of gross PPE. However, when this capacity is brought online, it will begin being depreciated and we will see the depreciation percentage as a total of gross PPE begin to return to normal. For reference, if we apply the more normal 1.7% depreciation percentage to the current gross PPE, depreciation expense would be more than 5 cps higher than reported in the 12/20 quarter. We reiterate that we see no indications management is playing with depreciable lives, but this should remind investors that a sizeable cost related to the new capacity is already on deck.

Becton, Dickinson and Company (BDX) 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 upgrading our earnings quality rating of BDX to 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

BDX's revenue jumped by 25% in the 12/20 quarter as Integrated Diagnostic Solutions revenue doubled as a result of COVID test demand. This drove non-GAAP EPS of $4.55 which was $1.39 ahead of the consensus estimate. Our rating increase reflects a leveling out in receivables factoring although longer-term issues such as material intangibles add-backs and a high debt load remain concerns.

What improved?

- Factored receivable DSOs fell by 2 days versus the year-ago quarter and were flat sequentially. Total adjusted receivables DSOs also fell 7 days YOY and 4 days sequentially. It does not appear that cash flow growth received an artificial boost in the three months ended 12/20 from accelerated factoring but this trend should be monitored going forward.

What deteriorated?

- BDX’s effective adjusted tax rate fell to 14.6% in the 12/20 quarter from 15.3% a year ago. This added about 2.5 cents to EPS in the period. This is not material given the size of the earnings beat in the quarter.

What to watch

- We have criticized BDX in the past for adding back the amortization of intangible assets to its non-GAAP earnings figures. While virtually all med-tech companies do this, the distortion on BDX’s earnings is especially large as its adjustment amounted to almost 40% of non-GAAP EPS for the trailing-12 month period ended 12/20.

- The 2017 acquisition of Bard left BDX with a substantial net debt load which currently sits at $14.5 billion or 3.3 times adjusted EBITDA. Also, keep in mind that the company has an additional $2.4 billion in litigation accruals related to product liability lawsuits not included in these debt figures.

Supporting Detail

Reduction in Factored Receivables

We have noted in previous reviews that BDX maintains a receivables factoring program under which it sells accounts receivable to third parties. The transfers are accounted for as a sale and receivables are removed from the company’s balance sheet. Before the 12/19, quarter, BDX did not disclose the amount of transferred receivables as they were considered immaterial. However, BDX reported in the 12/19 quarter that its balance sheet excluded over $300 million in receivables that had been transferred to third parties. This amount has moved between $200 and $340 million in the quarters since. To calculate a useful DSO figure, we must add back the receivables that have been transferred to third parties but are still outstanding at the end of the period. The following table shows this adjusted DSO breakdown for the last eight quarters:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Sales	$5,315	$4,784	$3,855	$4,253	$4,225	$4,584
Balance Sheet Receivables	$2,370	$2,398	$1,993	$2,160	$2,074	$2,345
B/S Receivable DSOs	40.6	46.1	47.0	46.2	45.2	47.1
Factored but Outstanding	$284	$256	$317	$246	$328	nm
Transferred DSOs	4.9	4.9	7.5	5.3	7.1	0.0
Adjusted DSOs	45.4	51.0	54.5	51.5	52.3	47.1

We can see that DSOs based on receivables that have been factored are down significantly from a year ago and flat sequentially. Also, total adjusted DSOs are down YOY and down sequentially. We do not see evidence of cash flow growth for the three months ended 12/20 receiving an artificial boost from factoring activity. This trend should be regularly monitored for signs of an acceleration in factoring.

Stryker Corp. (SYK) 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 downgrading our earnings quality rating of SYK to 3- (Minor Concern) from 4+ (Acceptable)

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

Summary

SYK reported EPS of $2.81 in the 12/20 quarter which was 26 cps above consensus. However, over 25 cps was traceable to the adjusted effective tax rate falling by half, a benefit the company does not expect to continue. We also see the rising add-backs of restructuring charges and amortization of intangibles from ongoing acquisitions eroding the quality of reported earnings. This prompts us to reduce our earnings quality rating back to 3- (Minor Concern.)

What deteriorated?

- Over 25 cps of the 26 cps earnings beat can be traced to the adjusted effective tax rate falling to 8.0% in the 12/20 quarter from 16.3% in the year-ago period. Management attributed this to “one-time operational fluctuations that arose due to the pandemic, with a mix of foreign losses related to lower foreign manufacturing activity, combined with reduced U.S. sourced income that resulted from the sharp drop in sales at the end of the year.” The company does not anticipate a repeat of these factors and expects the 2021 effective rate to return to the 16% range.

- SYK added back $159 million in pretax “Restructuring-Related and Other Charges.” On a trailing 12 basis, this brings total restructuring charges added back to almost 15% of adjusted profits. These sizeable and recurring charges reduce the quality of reported earnings.

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Restructuring and Other Charges	$159	$26	$170	$42	$58	$40

- In November, the company completed the acquisition of Wright Medical for over $4 billion. Of the $5.2 billion recorded as goodwill and intangibles, over 65% was recorded as goodwill which will not be amortized. The company does not give a specific estimated useful life over which it will amortize the Wright intangibles, but it does disclose that the average amortization period for all intangibles is 14 years. This comes to approximately $100 million in incremental annual pretax amortization. However, the company will add this back to its non-GAAP results along with any integration and restructuring actions thereby eliminating the cost of the acquisition from adjusted results. This is becoming more of a distortion as the company has made several sizeable acquisitions over the last few years and free cash flow after dividend and buyback regularly fails to cover acquisition spending. We estimate that the incremental amortization from the Wright deal will bring the total of intangible amortization added back to about 18% of adjusted profits.

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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