BEHIND THE NUMBERS

Quality of Earnings Analysis

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Iron Mountain (IRM) 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 reducing our earnings quality rating of IRM to 1- (Strong Concern).

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

Summary

IRM's 4Q20 adjusted FFO of $0.60 beat forecasts by 7-cents. The first thing people should be aware of is IRM changed the definition of FFO (and EBITDA and AFFO) for the quarter. It now excludes the losses from its equity-method JVs when it adds back "other expenses." It also adds back stock compensation now but removes growth cap-ex for non-real estate from AFFO. IRM picked up 1-cent by adding back stock compensation. It also reported a tax benefit of -$3.7

million. That was fueled by reversing $15.8 million in allowances and accruals in its tax accounts. That amounts to 5-8 cents in FFO (Over 5-cents just looking at the $15.8 million and just under 8-cents if viewing the y/y $22.4 million swing when the allowance was rising the year before). Another catch-all of "other, net" for taxes added $4.5 million more or 2-cents in FFO. This is normally +/- a fraction of 1-cent. There is still 3-cents coming from not recognizing principal payments on financing leases. Plus, FFO adds back FX losses which were $36.1 million in 4Q. That is 10-cents in FFO (assuming it was taxed at 21% since foreign operations do not get REIT treatment). We still remain skeptical of the restructuring too. IRM continues to say that severance will be the number one expense of $450 million, yet it is only $68 million of the $243 million incurred so far. Also, shouldn't cutting people – especially during Covid – be the quickest thing to do for cost-cutting? We still wonder if the professional and management fees lumped in the restructuring charges include several ongoing costs that are being added back. Dealing with $450 million in expenses, it wouldn't take much to pick up 1-2 cents in any given quarter.

What is weak?

- **Reversing valuation allowances on taxes from 2019 to 2020 as well accruals for tax liabilities declining greater than expected along with a miscellaneous catch-all helping – allowed IRM to record a benefit for income taxes in 4Q.** (See Discussion Below). Looking at this on its own, it helped 4Q20 FFO by 7 cents. Looked at as the swing from 2019, it helped FFO by 8 cents.

- **FX added 10-cents to 4Q20 FFO.** As part of FFO, IRM adds back Other expense/(income). This account consists of FX transaction gains/losses, Valuation changes in mandatory redeemable non-controlling interests, JV income/losses, and charges related to early debt extinguishment. As part of its adjusted FFO, IRM adds back this catch-all of items. The FX transactions are broken out:

FX transactions	4Q	3Q	2Q	1Q
2020 (G)/L	$36.1	$29.6	$1.5	-$37.4
2019 (G)/L	$44.7	-$18.3	-$19.3	$17.7

  IRM is involved with foreign subsidiaries and it has borrowed money in foreign currencies so it has hedges in place and settles transactions that convert back into dollars. In other words, this is an ongoing expense. It can be lumpy. In 2Q20, they only added back $1.5 million. In 4Q20, it was $36.1. We are simply going to assume this is a non-REIT activity and net it of 21% taxes. That makes this a 10-cent benefit to reported FFO for 4Q.

- **More changes in definitions of REIT Metrics at IRM.** In previous periods, IRM has changed parts of presentations where it discloses less about the negative organic growth in records storage or the costs of servicing new clients in that business. In 4Q20, they

changed the definitions of its REIT metrics of FFO, AFFO, and EBITDA. They now leave in JV losses and omit stock compensation and omit non-real estate growth capital spending. We already regarded IRM's original definitions as aggressive because several on-going cash costs were ignored such as costs to acquire a customer, pick-up/delivery costs of his records, etc. IRM books those cash costs into the financing section of the cash flow statement and capitalizes them. They aren't impacting income metrics because they add back the amortization.

- The true debt levels and dividend coverage look much weaker when accounting for all the actual cash costs. Using AFFO, which ignores many cash items like financing lease payments and service costs for records clients, investments in JVs, growth Cap-Ex, the dividend is about 80% of AFFO. On actual free cash flow, IRM isn't close to covering the dividend with internal funds. They can't do sale lease-backs forever to plug the hole. Debt to adjusted EBITDA is 5.75x. We think it is closer to 6.5x adjusting for the recurring operating cash costs. Also, those cash costs may rise after Covid and lease costs will rise with sale lease-backs.

What to Watch?

- The Restructuring called Project Summit has some odd features. The largest part of the cost and savings is always listed as cutting employees – yet the cost incurred so far has severance as only 28% of the total. It was announced before Covid. Shouldn't that have sped up lay-offs? Yet, IRM didn't seem to take advantage of that. It is also odd that the size of the restructuring charges is rising, normally the biggest charges hit early in a restructuring. We wonder of some employees targeted to be cut are still working there and perhaps having some of their wages classified into the restructuring. Also, could on-going management time/trips related to the restructuring be going into the charges too?

IRM's Tax Assumptions Drove the 4Q Results

Because IRM has a REIT structure, many would expect taxes to be a minimal issue here. However, 38% of revenue and 39% of long-lived assets are overseas. Those countries do not necessarily recognize real estate as a tax-free proposition. It also has equity-method investments overseas. IRM still has operating entities that manage the real estate assets. These are labelled at TRS (Taxable REIT Subsidiaries) and they pay corporate taxes. Some states tax REITs and TRS different than the Federal IRS. Thus ordinarily, IRM's tax table shows up as Income at 21% tax rate, a non-TRS adjustment, and a state and foreign adjustment. An examination of these parts shows what would be expected – a fairly stable tax rate:

IRM normal Taxes	2020	2019	2018
Pretax Income at 21%	$78.3	$68.9	$86.2
REIT tax Adjustment	-$60.4	-$40.6	-$35.2
State taxes	$2.3	$2.1	$1.6
Foreign Difference	$9.5	$8.6	$1.0
Disallowed Foreign issues	$20.2	$14.2	$0.9
Taxes owed	$49.9	$53.2	$54.5
Effective Tax Rate	13.4%	16.2%	13.3%

The next thing is IRM has disputes in its taxes where it has accrued liabilities. When there are settlements, the time for the IRS to dispute lapses, or the size of the accrued liability declines, this accrual can get larger or smaller. Then there are NOLs that can be used at times to lower taxes and combined with the accrued liabilities, IRM has a valuation allowance against these items that can change based on the likelihood these tax items will be realized or not. There is also a catch-all of “Other” which IRM does not explain. When we look at what changed from the table above to the company’s actual taxes owed – the changes in three accounts are the difference:

IRM normal Taxes	2020	2019	2018
Taxes Owed from above	$49.9	$53.2	$54.5
Taxes on Income Stmt.	$29.6	$59.9	$42.8
Difference	$20.3	-$6.7	$11.7
Chg in Accrual/Settlement	-$7.4	$0.5	-$14.0
Chg in Valuation Allowance	-$8.3	$6.2	$3.6
Other Tax Issues	-$4.5	$0.0	-$1.4
Total	-$20.2	$6.7	-$11.8

Coming into 2020, IRM guided that it could reach a net benefit from settlements and reversing accruals of $4.6 million. It saw a net $7.4 million figure. In 2018 and 2019 it was boosting the valuation allowance meaning it viewed its ability to recover its tax assets like NOLs as less likely. During Covid, they suddenly reversed this reserve by $14.5 million? Looking at several years, the Other tax issues are normally a small +/- figure. In 2020, it’s a $4.5 million benefit.

Also, we think all this tax benefit hit heavily if not all in 4Q. In 1Q, the tax rate was 13% - which is largely the normal rate. In 2Q, income was only $2.6 million so the effective income tax was much higher because the foreign tax issues were a much larger part of the total picture. In 3Q, the tax rate was 26.5% because much of the restructuring charges occurred in the US REIT assets – which being non-taxable entities did not provide a tax shield from the restructuring charges.

Look at 4Q, restructuring was $65.7 million vs. $48.4 million in 3Q – so the tax rate should have had upward pressure just from that. Instead, the tax rate fell to -1.5% a benefit of $3.7 million. There are several ways to view this:

- The reversed accrual came in as a $7.4 million benefit which is 3-cents. Or one could say it exceeded guidance from 2019 by $2.8 million and added 1-cent to FFO.

- The decrease in the valuation allowance was $8.4 million, which added 3-cents. Or one could say that the valuation allowance swung by $14.5 million y/y and added 5-cents to FFO.

- The Other was another 2-cents in positive and is normally immaterial.

In our view, the entire "beat" on estimates came from these tax issues. It is also worth considering that even though this 4Q20 negative tax rate came from out of the blue – a couple of signs point to a rising tax rate for IRM:

- It expects another $200 million restructuring charge in 2021 against tax free assets so there isn't a tax shield there.

- IRM is trying to expand internationally more – which also plays against the REIT structure.

Iron Mountain Redefined Its Metrics

We already had issues with IRM's non-GAAP metrics as they were already ignoring several ongoing costs and they provided a far different picture of the actual operations than cash flow did. The basics for REITs are:

- FFO – Funds from Operations – designed to show REIT cash income as Net Income + real estate depreciation + gains/losses on real estate sales. IRM already modified this to add back restructuring costs, transaction costs, and "other income," which is primarily FX gains/losses, JV income/losses, and debt financing costs. It has modified it again keep JV income in the mix and add back stock compensation – it has effectively been increased:

FFO changes	4Q20	3Q20	2Q20	1Q20
Old definition	$173.4	$176.2	$152.2	$169.8
New definition	$173.5	$181.7	$166.2	$172.1

- Adjusted EBITDA makes the same additional adjustments as FFO. It will add back stock option expense and leave in the JV losses.

- AFFO – Adjusted Funds from Operation – Is a metric to show basic free cash flow. It starts with FFO and adds back stock compensation, all amortization, non-real estate

depreciation and subtracts a maintenance capital spending figure. IRM already had an inflated AFFO in our view because it capitalizes several ongoing expenses that are capitalized, amortized and added back to AFFO. It also added back reductions in revenue from below-market leases and withdrawal fees. It was subtracting the recurring maintenance capital spending on real estate and growth capital spending on non-real estate. The latest definition will benefit from the higher FFO to start with and will now use a recurring capital spending figure for all businesses. AFFO has also been increased due to these changes as capital spending is lower and FFO is higher along with some changes in tax reconciliations:

AFFO Changes	4Q20	3Q20	2Q20	1Q20
Old definition	$187.0	$213.1	$249.5	$231.3
New definition	$190.8	$216.4	$249.7	$230.7

We consider the new metrics to further overstate actual results. People count on stock compensation as part of their pay – it should not be ignored as a recurring expense. Plus, we can look at all the cash expenses at IRM in operating the business such as picking up and delivering records, payments to acquire customers, and financing lease payments that AFFO is ignoring under both the new and old definition and compare it to actual cash flow, and the real numbers look much more subdued.

Here is the picture IRM shows for its dividend:

	2020	2019
AFFO New	$887.5	$867.0
Dividend	$716.3	$704.5
Payout %	80.7%	81.3%

Here is the actual cash flow at IRM – and this adds back stock compensation too:

	2020	2019
Cash from Ops	$987.7	$966.6
Capital Spending	$438.3	$693.0
Acquisitions	$118.6	$58.2
Acquired Customers	$4.3	$46.1
Customer Inducements	$10.6	$9.4
Fulfill costs/commiss	$60.0	$76.2
JV Investments	$18.3	$19.2
Principal on Fin. Leases	$47.8	$58.0
Free Cash Flow	$289.8	$6.5
Dividend	$716.3	$704.5

Obviously, IRM is not covering the dividend at all. It is making up the shortfalls by borrowing and doing sale-leasebacks on real estate assets. That's fine in the short-term, but they can't do that forever and the following years they have a new lease expense to pay that lowers cash flow and they still have a dividend to pay without more assets to sell. People should note that the storage business where these various cash costs occur is already a negative growth business. What happens if IRM does not pay to acquire new records to store and pick them up? Also, let's consider a couple of other points:

- If we assume just the maintenance capital spending IRM uses in AFFO of $143 and $138 million instead of total capital spending of $483 and $693 million – That difference of $340 and $555 million still isn't enough to plug the shortfall. Plus, IRM is planning to continue growing the data center business – they have to pay for it somehow.

- 2020 spending on acquiring new customers and fulfillment was depressed due to Covid. Those figures will likely rise going forward.

- Cash flow from operations is also helped by IRM securitizing receivables. That added $85 million in 2020 and $272 million in 2019.

- Borrowing forever seems unlikely too. IRM can tout its EBITDA of $1.5 billion the last two years and the net debt of $8.5 billion is still 5.75x EBITDA. But, if we adjust for the fulfillment costs, customer inducements, and finance lease payments – which are all cash outflows – EBITDA is closer to $1.3 billion. Debt net of cash is $8.5 billion is closer to 6.5x (2021 adjusted EBITDA or $1.477 billion less cash costs is $1.354 billion and we believe those costs were about 50 million light from Covid). That's before adding in higher operating lease costs.

We also want to point out that this is not the first time IRM has changed its presentation of results. In recent quarters, is started to lump more costs together and it stopped showing the decay of its storage business which used to give figures for how much was lost, how much was shredded, and how much pricing helped/hurt.

The Restructuring Plan Has Some Peculiar Issues

Iron Mountain is certainly not the first company to do a big restructuring program. The goal is to spend $450 million and achieve $375 million in cost savings. We are just looking at the plan and several things look odd:

- The number one target for cost savings is severance and getting rid of employees. It is also routinely listed as the first item on where the $450 million will be spent.

- However, severance has been a small part of total spending – at only 28%. It was $20.9 million spent in 4Q19 and then only $47.3 million more in all of 2020. IRM is saying 70% of all its workforce reductions were completed at the end of 2020. That is surprising too – why wouldn't that accelerate with Covid and be completed by now?

- As part of the severance, IRM will cut upper management of VP and above by 45%. Those should be larger salaries and generate cost savings. What we wonder is "are some of these people still working there?" Also, are some wages for actual IRM work being lumped into these restructuring charges and added back as one-time events?

- Also surprising to us is the size of the restructurings are getting larger as time moves forward. We normally see a restructuring have the biggest impact in the first period it is announced as leases are bought out, assets marked down, a large number of lay-offs occur. At IRM, the charges are rising a year later. Plus, 44% of the total spending is estimated to occur in the last year (2021):

	4Q20	3Q20	2Q20	1Q20	4Q19
Restructuring	$65.7	$48.4	$39.3	$41.0	$48.6

- So far, the item labeled "professional fees and other costs" is 72% of the restructuring cost. The bulk of the restructuring is for the US-based records storage business. IRM has been around since 1951. Who are these professionals coming in who know more about that business than IRM people? The sheer size of this relative to the severance also makes us wonder if there are some ongoing costs in here too. Is a VP who is staying allocating one-third of his salary to the restructuring in 2020 for example? Is a trip by management to visit locations in California and Colorado being added to the restructuring as they went to oversee restructuring plans there? One of the other things in here is data conversion costs – that sounds like that could include normal ongoing expenses of converting customers' paper records to digital.

Keurig Dr Pepper Inc. (KDP) 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 2- (Weak) rating.

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

Summary

KDP missed forecasts by 1-cent with adjusted EPS of $0.39 for 4Q20. It is worth noting that it enjoyed a lower tax rate that boosted EPS by 1-cent too. The company blamed some headwind on a $30 million gain from a sale-leaseback in 4Q19. But that gain was obviously known when KDP set guidance for 4Q20 and there were also two losses totaling $17 million on other asset sales from 2019. We also note that with the 10-K we can see that it cut marketing by $181 million during the year and R&D by $12 million. That is 10-cents in EPS during 2020. This has been helping EPS too and certainly helped in 4Q as well. KDP lists lower marketing as a driver for earnings growth in every division in 4Q.

What is strong?

- Coffee maker sales were up in 28% in 4Q. That in turn helped spur pod sales growth of 7.4%. It will be interesting to see if these additional equipment sales continue the coffee growth. Also for such strong demand, pricing was down 1.3%. We would believe that after initial pantry stocking for these new machines, volume growth will match actual coffee drinking.

- Concentrate sales could help 2021. This was the area most hit by Covid with lower restaurant sales. Volume growth remained negative at -4.5% vs. -4.8% in 3Q and -11.4% in 2Q, but easy comps here could help KDP hit guidance of 3%-4% sales growth.

What is weak?

- Payables rose again! Payables are now $3.74 billion up $564 million from 4Q19 while cost of goods sold rose a mere $112 million. Days Payables now are at 252 days up from 234 last year. The amount factored was $2.6 billion.

- We still see growing payables as KDP's way of refinancing its bank/bond debt and claim it is deleveraging. In 2020, KDP says its debt is $13.4b against adjusted EBITDA of $3.7b for a ratio of 3.6x. However, if we add in the $2.6b in factored payables and the company credit line called a "structured payable" – the ratio is 4.4x. KDP has been refinancing from long-term debt to short-term debt with the factoring set-up.

- There are several catalysts that can unwind this short-term debt in our view which can happen if the debt is downgraded and it is on negative watch:

    - Cash from operations of $2.46 billion was 25% higher from payables rising $624 million. KDP is reporting that its dividend of $1.07 billion annualized will be less than 50% of free cash flow. Cash flow was also inflated by the CARES Act deferring $59 million in 2020 and the use of financing leases moving $52 million of the lease payment to the financing section – Without all that recurring, Cash from Operations falls to $1.7 billion and capital spending was $461 million for free cash flow of $1.26 billion. The new dividend is $1.07 billion for an 85% payout ratio.

    - The marketing spending needs to return. KDP pulled nearly $200 million out of that area in 2020. It is forecasting 3% sales growth - $350 million – it had a 27% adjusted margin – that's less than $100 million in incremental cash flow against a $200 million boost in marketing. That should push cash flow down too.

    - We have noted that ROI here is very low. Total capital is $40 billion counting the $2.6 billion in factored payables. Adjusted EBITDA was $3.7b and that includes $200 in marketing cuts. Adjusting that to $3.5b gives an ROI of 8.8% and that doesn't include that KDP has a growing lease expense after several sale-leaseback deals. Plus, KDP sees pressure from commodity, wage, and logistics costs coming.

    - We noticed that KDP cut the discount rates in 2020 to value its intangible assets as well. The discount rate fell to 6-10% from 2019's 7.25%-13%. As a result, they boosted the fair market value of their intangibles to $29 billion against the carrying value of $19.7 billion. However, a 50bp increase cuts $3 billion off the fair market

value. If there are cash flow pressures such as not being able to pull another $624 million out of payables and or interest rates increase – we don't think the discount rate changes by 50bp – it may go up 200-300bp.

What to watch

- Latin America results continue to be overstated in our view with KDP touting growth before FX hits. Looking at the four divisions, coffee had -1.3% pricing, packaged beverages +1.8% on pricing, concentrates -1.3% on pricing, but Latin America had 6.0% pricing gains. Latin America also had a 6.0% hit on negative FX.

- For all the sale-leaseback transactions in late 2019 and early 2020 that generated cash used by KDP to retire debt, we still believe lease costs should be rising more. Operating Lease expense rose from basically $20 million per quarter in 2019 to $28 million per quarter in 2020. But, KDP has guided to more leases that have not commenced in every quarter of 2020 and after 4Q it was still $625 million in leases. Those are expected to begin in 1Q21 and 3Q21.

Air Lease Corp. (AL) Earnings Quality Update

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 of 4+ (Acceptable)

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

Summary

AL beat forecasts by 15-cents in 4Q. EPS was still down from $1.42 to $0.94 y/y. Adjusted EPS was $1.30 vs. $1.92. There are three main spots for the lower y/y earnings:

- AL had $21.2 million in rent due that it did not recognize because it was deemed uncertain to be collected or part of a lease being reworked. This was 15-cents of GAAP EPS and 19-cents of adjusted.

- AL's balance sheet is carrying more debt than normal as it boosted liquidity during Covid and delays in planes arriving from Boeing and Airbus. This higher interest expense hurt EPS by 5-cents and 6-cents. It also didn't produce as much lease income as expected.

- AL earns income by selling aircraft too. The volume of trading dropped off significantly from $44.2 million to $5.5 million. That in turn lowered SG&A, which fell by $10.9 million. AL does say much of that is from lack of trading transactions. There were $33 million in gains in 4Q19 and $0 in 4Q20. Just the y/y change in gains hurt EPS by 23 cents and adjusted EPS by 29 cents.

The fact that AL has not seen an impairment and its planes are in high demand are reasons we do not believe they have a fleet problem. The delays in new deliveries continue and that may make it difficult for AL's aircraft trading business to see normal volumes return in the near future.

What is strong?

- Collection rates improved to 88% in 4Q, compared to 86% in 3Q. Customer deferrals continue to be repaid. Most deferrals are a few months in duration. At the end of 3Q, AL noted it had received payments of $60 million on $201 million in deferrals. At the end of 4Q, $96 million has been collected on $240 million of deferrals.

- Customers continue to want to fly their planes with the lowest operating costs that are most efficient. These are often newer planes which is what AL specializes in. Even in the worst of Covid, AL planes were still flying and customers reworking fleets wanted to keep the new equipment. In our view, if AL made it through 2020 without impairments to fleet value, this risk should be lower going forward. The values are benefitting from high demand and long delays on delivery from Boeing and Airbus.

- The argument can be made that AL has too much liquidity at the moment. Normally, AL plans on having 80 new aircraft arrive worth $5-$6 billion per year and it sells 20-40 units to recycle some capital back into new planes covering about 20% of the cash needs. However, in 2020 only 26 new planes were delivered vs. 46 expected. AL only spent a net $2.5 billion in 2020 and that included buying 15 planes on the secondary market. It expects more delays in delivery for 2021 too. It is holding $1.7 billion in cash and an untapped $6 billion credit line to deal with capital needs. We prefer a liquid company over an illiquid one, but the $1.7 billion in cash is not making AL any money. Retiring $1.0 billion in debt would likely generate about 7-cents in quarterly EPS via reduced interest expense. Or AL could retire 20 million shares at $50 and add 23-cents in EPS per quarter. We're just illustrating these options to show there are some potential earnings tailwinds for AL going forward beyond simply having the airline market recover further. Even if they work down some of the cash in 2021 by paying cash for new planes – it should be more accretive to EPS than its standard model of financing the purchase.

What is weak?

- AL expects to see more lease deferral requests as well as requests for lease restructuring in early 2021. These situations normally include extending the lease term and can often mean a sale-leaseback for additional planes with the client. These deals may result in more lease revenue over time, but early on, it may reduce total lease payments in 2021.

- When the leases are deferred, AL normally still records the lease revenue but does not collect the cash. As noted above, a growing percentage of the deferrals are being repaid. Only when AL cannot be assured of cash collection does it exclude recognizing lease income until cash is received. That is the $21.2 million in lower revenue for 4Q20.

- As delays from Boeing and Airbus continue, AL may not get the same number of planes it expects in 2021 or 2022. At the end of 2018, AL had 83 planes scheduled for delivery in 2020. That forecast was cut to 46 at the end of 2019. As noted above, only 26 arrived in 2020. Delays could reduce earnings growth. At the same time, AL is very disciplined in selling planes that begin to reach 7-8 years old. They sold 30 planes in 2017, 15 in 2018, and 30 in 2019. They sold only 8 in 2020. The sold figure should increase in the future and it may be tougher to replace the number of planes. They noted in the 10-K, *"Our aircraft sales program has been impacted by the pandemic, primarily because we elected to sell fewer aircraft in 2020 because of additional delivery delays of our new orderbook aircraft from Boeing and Airbus. We had no aircraft sales during the fourth quarter of 2020."*

What to watch

- AL is still issuing debt at lower rates. 93% of debt is unsecured senior notes. The company has about $2.0-$2.5 billion of debt maturing annually for the next several years. Every 50bp that AL sees in higher rates upon roll-over of each $2 billion would cost it about 2-cents in quarterly EPS.

- AL did note that where it could see a pick-up in business even amid slower rates of delivery is having more airlines opt to lease even new planes that they had expected to buy – Having the Leasing Market Grow as a percentage of the market. Essentially, AL's cost of capital is much lower than the airlines and it has more liquidity. Both situations could result in the airline still coming out ahead if it does more leasing with AL. To make this more clear, let's say there are 100 planes on order and Boeing only completes 50 or half the expected deliveries. AL has 40 of the planes and Airline Q has 30 of the 100. Basically, both would get half their order, 20 and 15. But if Airline Q decides it makes more financial sense to lease more of the 30 planes, AL could end up with as many as 35 planes despite the expected deliveries being off by 50%, and eventually it could gain as many as 70 instead of the expected 40.

  According to Steve Hazy, the Executive Chairman on the call, ***"It also creates a situation where the airline recognizes that our cost of funds are significantly lower than what the airline has to pay. So in effect, even though we can have a very strong profit margin on these leases going forward, from the airlines point of view it is still a dramatic savings over what they would have to pay to finance their direct buy aircrafts.*** *So we're seeing this seismic shift for the lessors, both in terms of sale leaseback opportunities, which is less, our sort of appetite basket, but more towards filling in these gaps using our slots, our direct orders in the years to come. Particularly, right*

now the focus is on 2022 and 2023 and through the spring of 2024. ***We're getting a lot of requests from airlines to kind of shift their order and backfill with Air Lease leases."***

"It will be an interesting process to see how balance sheets of companies on the airline and manufacturers side evolved. Despite most lessors experiencing margin pressure during the pandemic, many still have stronger credit ratings than the airlines that they service themselves, and we expect many will turn to the aircraft leasing companies to help finance the airline industry.

After years of being asked the question, 'when will leasing hit 50% of the market?' I can tell you as a fact that 55% of all aircraft deliveries by Airbus in the year 2020 were leased. So we are now at a point where we expect that aircraft lessors will finance 50% or more of all new aircraft deliveries going forward in the near future."

Zimmer Biomet Holdings (ZBH) 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 of ZBH at 3+ (Minor Concern) rating

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

Summary

ZBH reported non-GAAP EPS of $2.11 which was 5 cps ahead of the consensus. We view the company's discontinuation of its receivables factoring program as a positive for the quality of future cash flow growth. However, we are reluctant to raise our earnings quality rating on ZBH given the extensive list of non-GAAP add-backs.

ZBH announced in the quarter that it will be spinning off its Spine and Dental business to shareholders in a tax-free distribution of shares in a new publicly-traded company. The spin-off is not targeted for completion until mid-2022.

What is strong?

- The company's rising use of its factoring facilities was a focus of concern for us in past reviews. However, we raised our rating in late 2020 as the company began to throttle back on the rate of factoring. ZBH discontinued its factoring programs in the fourth quarter for its US and Japan operations. The company estimated that discontinuing the programs cost it $300 million in cash flow growth in 2020. Note that the company still sells receivables to third parties in Europe. It has never been involved in the collection process in Europe and has not disclosed detail on European receivables such as amounts factored but still outstanding or payments received. It remains to be seen what information the company will disclose regarding the European factoring program going forward.

Regardless, we view the termination of the US and Japan facilities as a positive for the quality of future cash flow growth.

What is weak?

- The effective non-GAAP tax rate fell to 15% in the 12/20 quarter from 16% in the year-ago fourth quarter. This added about 2.5 cps to EPS growth. The company attributed this to geographic mix and discrete tax benefits from recent audit settlements. This was likely lower than what most analysts were predicting. Management is predicting a "modestly higher" tax rate for 2021.

- An increase in other income added almost 1 cps to earnings even after non-GAAP adjustments for "other charges." This account includes items such as changes in the value of equity investments and non-operational pension amounts. Given that the company considers items such as litigation charges and quality remediation costs which occur every quarter as necessary add-backs to earnings for non-GAAP purposes, we are surprised that it also does not remove gain and losses from equity investments and unusual pension benefits.

- About unusual pension benefits, disclosures indicate the total pension expense fell by 4 cps for the full year largely due to lower recognized actuarial losses. Unfortunately, ZBH no longer discloses pension expense on a quarterly basis so we cannot see which quarters benefited the most from the expense decline.

What to watch

- We continue to see the company's long list of adding back "non-operating" expenses to adjusted results as eroding the quality of non-GAAP earnings. Case in point, the company regularly adds back excess and obsolete inventory charges which amounted to roughly 11 cps in the 12/20 quarter. Also included in the 12/20 quarter adjustments were 4 cps for quality remediation expenses which occur every quarter and 3 cps for "other charges" which include "costs related to legal entity, distribution and manufacturing optimization, including contract terminations, gains and losses from changes in fair value on our equity investments, as well as our costs of complying with our Deferred Prosecution Agreement ("DPA") with the U.S. government related to certain Foreign Corrupt Practices Act matters involving Biomet and certain of its subsidiaries."

Stanley Black & Decker, Inc. (SWK) 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 of 3+ (Minor Concern)

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

Summary

SWK's fourth-quarter non-GAAP earnings of $3.29 topped the consensus by 27 cps. We did identify in excess of 15 cps of one-time boosts to the quarter, but the earnings beat remains well intact without them.

What improved?

- Cash flow growth was strong and free cash flow conversion was over 130%.
- Factored receivables fell to 1.9 days of sales from 2.5 in the year-ago quarter. Factoring remains under control and did not impact the quality of cash flow growth.

What eroded?

- The company's tax rate adjusted for charges was 13.6% in the 12/20 quarter versus 15.8% in the year-ago fourth quarter. We saw no discussion about the rate or the cause of its decline in the press release or call. On the 9/20 quarter conference call, the company was projecting a 16-17% tax rate for full-year 2020. This would have required the tax rate in the fourth quarter to be more than 17% which would imply an earnings boost of 13 cps

for analysts expecting that rate. This could account for about half the reported earnings beat.

- The provision for warranties during the quarter fell to 0.78% of sales compared to 0.95% in the year-ago quarter. We estimate that this could have added over 3 cps to earnings in the quarter.

What to watch

- SWK regularly adds back "Merger and Acquisitions Related and Other Charges" to arrive at its non-GAAP results. These are typically presented as a single line item in its press release reconciliations of GAAP to Non-GAAP results. The 10-Qs and 10-Ks offer a little more insight into the makeup of the charges. For the 12/20 quarter, we estimate that roughly $75 million of pre-tax add-backs were related to cost reduction plans, facility-related costs, and business transformation costs. This amounted to about 12% of adjusted pre-tax earnings. Charges of such size are common which we believe erodes the quality of non-GAAP results. This is the major factor preventing us from giving the company a 4 (Acceptable) rating.

- 2021 will be very front-loaded. Management is forecasting full-year organic growth of 4-8% with 27-32% growth in the first half being partly offset by -12% to -7% growth in the second half. The incredibly strong recent growth is being driven by 1) a pandemic-driven DIY surge, 2) a push to e-commerce where the company has an advantage, and 3) a surge in new and pre-owned home sales. 1Q and 2Q 2020 sales were certainly weak, posting -6% and -16% growth rates, respectively. However, 1Q trends should be watched carefully for any signs sequential growth is weaker than expected.

Roper Technologies (ROP) 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 downgrade our earnings quality rating to 4- (Acceptable)

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

Summary

ROP reported adjusted EPS of $3.56 in the 12/20 quarter which was 7 cps ahead of the consensus. Our downgrade largely reflects the ongoing string of acquisitions which is leading to both a buildup in debt and an increase in the add-back of intangible amortization to non-GAAP earnings.

What improved?

- We regularly monitor deferred and unbilled revenue growth relative to Application and Network segment revenues. While acquisitions can distort these trends, we currently see no material signs of the company becoming more aggressive in recognizing revenue.

What eroded?

- ROP continues to push forward with acquisitions which is powering growth and transitioning the company to more of a software company and less of an industrial. However, this is driving up net debt which now stands at 4.7 times adjusted EBITDA, (not including pro-forma impact of recent acquisitions.) There is no buyback to be cut and free cash flow before acquisitions is more than sufficient to provide for debt reduction which reduces the concern level some.

- We are most concerned by growth through acquisition strategies when there is no underlying organic growth and the company is spending capital just to drive the top line in the short-run. Virtually all ROP's revenue acquired in the last couple of years has been in the software/tech area. Using pre-pandemic 2019 results as a proxy, organic Application Software revenue and organic Network Software & Systems each rose by 5%. This makes growing by acquisition less of a concern, but we will continue to monitor this going forward. ROP supports dozens of seemingly unrelated software products which would seem to make growing organically more of a challenge. For example, its *Link Logistics* business provides software solutions to connect trucking capacity in Canada while its *Vertaforce* product provides cloud-based software solutions for practice management for insurance companies. Where is the synergy to be gained in those areas?

- The real concern from an earnings quality standpoint is the degree to which acquisitions have led to a buildup in goodwill and intangibles which now account for 90% of total assets. Goodwill amounts to over 65% of these assets and is not amortized. Amortization on the remainder is added back to non-GAAP results which ignores the cost of the acquisitions. The amortization add-back exceeded 30% of non-GAAP EPS in the 12/20 quarter so the distortion is growing.

- The company's adjusted tax rate for the quarter was 19.9%, below the 21.6% of last year's fourth quarter. This added almost 7 cps to earnings growth in the period, accounting for about 40% of the reported EPS growth. The 19.9% was in-line with company guidance for the quarter, so it should not be viewed as contributing to the earnings beat.

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.

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