BEHIND THE NUMBERS
Quality of Earnings Analysis

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Equinix, Inc. (EQIX)
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 EQIX with a 3- (Minor Concern) rating.

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

Summary

We understand the appeal behind EQIX stock. There is strong demand for data centers and numerous portfolios around the world want to own them. So, here's a liquid pure-play on that sector with a $61 billion market cap, and while the dividend is only 1.7%, it's growing the top-

line and dividend at 8%. The biggest risk we see is it relies on equity funding to pay for its growth both acquired and built internally. It already has net debt to EBITDA of 3.8x too. We can point to the pipeline companies that have been growing rapidly since 2004, offering good dividends and growth the whole time, but for the last 6-8 years – no one wanted their equity. We can point to new restaurants or retailers with high P/E ratios and growth stats as they open more stores until the law of big numbers hits and growth starts to slow – suddenly no one wants to pay 40x EPS for the stock. We think that could become a risk for EQIX as its growth rate has already slowed from over 20% four years ago to 8% last year and we think organic growth is likely much lower. Also, all the equity funding boosted the share count by 44% in five years diluting results on a per-share basis by 400-600bp annually.

We think the REIT metric of AFFO (Adjusted Funds From Operation) overstates the actual results here on several fronts. It ignores all costs with acquisitions, ignores principal payments on finance leases, ignores stock compensation that could become cash if employees see less upside in the stock, and has a declining maintenance capital spending figure that looks very low to name a few. Using the company's figure – this REIT is already 28x AFFO as it looks to fill shortfalls in capital spending and pay the dividend that is now growing faster than the top line.

What is strong?

- EQIX has refinanced some higher-cost debt lately to the point where interest expense is actually lower on a larger debt balance. Interest expense fell from $522 million in 2018 to $407 million in 2020. Debt is up 8% from $9.9 billion to $10.6 billion over that time and the company pumped up its financing leases by $400 million more.

- EQIX has a deep-pocketed partner for some foreign JVs in Singapore's Sovereign Wealth Fund. EQIX has sold existing assets into the JVs for a 20% interest in these deals that are expected to expand the total footprint with more properties. Recycling some capital has generated cash flow for EQIX, $334 million in 2020 and $359 million in 2019. Given EQIX's continual cash needs, this looks like a reasonable plan on the surface to become a 20% partner in a growth area that is part of its main business.

- As much as we think REIT metrics like AFFO (Adjusted Funds from Operations) can inflate results, EQIX covers its dividend with a 68% payout ratio after we made some adjustments for recurring items. That's tighter than the company's reported 43% payout ratio but there still is cushion.

What is weak?

- EQIX is not self-funding. It routinely runs a free cash flow deficit of $1.3-$2.0 billion after funding all of its growth areas for capital spending and acquisitions. It still has a dividend of $1.0 billion more to pay.

- The company is continually issuing more shares to pay employees, to fund acquisitions, and simply to fund other operations. The dividend yield is only 1.7% so that cost of capital is lower than debt or leases. It has further enticed investors with 8% annual dividend growth – so the total dividend outlay has doubled since 2016. More importantly, EQIX is reporting topline growth of 8%-10% and AFFO growth of 13%-16% - but dilution is cutting 400-600bp off those growth figures. Those growth figures include considerable acquisition-related gains too as well as new building – EQIX does not report organic growth, but we would wager it is lower than the 8%-10% reported top-line figure. We estimate the dividend outlay is growing at 2-3x the organic growth rate of EQIX.

- Heavy use of capital or finance leases inflates the various cash flow figures. The issue is the principal payment shows up as debt payments in the financing section of the cash flow statement. Only the interest portion is going through income into the cash from operations. The principal payment would cut cash from operations by 5%. AFFO would also be 5.3% lower.

- EQIX trades on AFFO at over 28x as the proxy for non-growth REIT free cash flow. We see several areas where AFFO ignores some sizeable expenses. Ignoring principal payments on finance leases is 5.3% of AFFO. Stock compensation is another 14% of AFFO and is being considered a non-cash item. Since AFFO is trying to show what the company's finances look like without growth – we would argue few employees would be clamoring for more stock at a 1.7% yield trading at 28x non-growing AFFO. They would likely want to be paid in cash and without the potential upside of stock appreciation, they may want even higher wages. The recurring maintenance capital spending in AFFO is at 1.1% of net PP&E. We think property renewal is required on a faster basis than 91 years. At 3% or 33-years, it would hurt AFFO by another 13%.

What to watch

- Depreciation lives look very long to us for a company dealing with tech infrastructure. At the moment, investing in data centers is a hot market so we understand the M&A market gives these assets premium values. But we think the special power and cooling needs

of some of this real estate and the fact technology changes often all combine to give these assets shorter effective lives. There are warehouse buildings being amortized over shorter lives as fulfillment methods change with e-commerce. Amortizing core systems over as long as 40 years sounds very long to us and even buildings over 12-58 years seems equally long for this industry. Capitalized software is being amortized over 3-10 years. Most companies we see use 2-5 years. Both EBITDA and AFFO used by EQIX add back depreciation expense so the actual life assumptions do not impact the REIT metrics. But we would watch for potential impairments in this area.

- Acquisitions have been numerous. With some data centers, the PP&E allocation has been basically 25%-60% in recent years, Intangibles 10%-30% with largely a 15-year amortization, and another 30%-40% going to goodwill and not being expensed at all. Again, the EBITDA and AFFO metrics add back the acquired depreciation and amortization as though these deals had no cost. We do not have a problem with a 15-year amortization of intangibles as that is well within the range of depreciation on PP&E built in-house. However, like depreciation above, we would watch for impairments in this area if technology changes. There have already been some minor impairments on assets sold to the new JVs.

- On basic metrics, EQIX spent $7.8 billion on acquisitions in the last five years, plus $8.75 billion on growth capital spending. The company is not self-funding as it runs a cash flow deficit of $1.3-$4.0 billion per year. So EQIX depends on being able to issue debt and additional stock to cover the shortfalls and also fund its dividend that is now over $1 billion per year as well.

    - With all this spending, growth including the greenfield builds and acquisitions is slowing from 14% to 10% to 8% in the last three years. Organic growth may be much lower than that.

    - Operating income to capital is an ROI of 5%. AFFO to capital is an ROI of 10% and we showed why we think AFFO is inflated above.

    - As a REIT that is growing its dividend at 8%, it still only yields 1.7% today.

    - Unless EQIX can issue stock at high multiples of 28x AFFO, this growth story could unravel in that EQIX cannot afford to make acquisitions and build new facilities at the same pace, which could drop the growth rate and slow dividend growth.

    - We're not calling this a catalyst at the moment– but a sizeable risk factor to watch.

Supporting Detail

Heavy Use of Finance Leases Inflates Reported Metrics and Cash Flow

Finance or Capital leases are accounted for more like debt than leases. In the case of an operating lease – rent expense covers both the actual rent and the implied interest expense and it reduces operating income in full as well as cash from operations. In the case of capital leases, the payment assumes interest expense and depreciation go through operating income. However, the principal payment is not reflected in income. It is also not reflected in cash flow from operations, where in fact the depreciation is added back to cash flow. The principal payment occurs in the financing section of the cash flow statement as a debt payment. With EQIX touting both Adjusted EBITDA and AFFO – the use of capital leases is increasing them along with cash from operations:

	2020	2019	2018	2017	2016
Cap Lease Payments	$115	$127	$104	$94	$114
Cash from Ops	$2,310	$1,993	$1,815	$1,439	$1,019
Leases % Cash Flow	5.0%	6.3%	5.7%	6.5%	11.2%
Adj. EBITDA	$2,853	$2,688	$2,413	$2,052	$1,658
Leases % EBITDA	4.0%	4.7%	4.3%	4.6%	6.9%
AFFO	$2,189	$1,931	$1,659	$1,437	$1,078
Leases % AFFO	5.3%	6.6%	6.3%	6.5%	10.6%

On the surface this is becoming a smaller inflation factor for the various metrics. However, it is still 15% of EQIX's total debt and these payments are not discretionary. Moreover, it is not as though EQIX is self-funding:

	2020	2019	2018	2017	2016
Cash from Ops	$2,310	$1,993	$1,815	$1,439	$1,019
Capital Spending	$2,283	$2,080	$2,096	$1,379	$1,113
Real Estate bought	$200	$169	$182	$95	$28
Acquisitions	$1,180	$34	$830	$3,963	$1,767
Free cash Flow	-$1,353	-$290	-$1,293	-$3,998	-$1,889

This doesn't even include the dividend or scheduled debt maturities like the capital leases.

Shares Are Being Issued Continuously

We always take the approach that paying people in stock has a cost – either through dilution or a cash outflow to repurchase shares (normally at a higher price). In the case of EQIX, they give stock to everyone. They are paying employees with it, issuing shares for deals, settling debt with it, and renewing ATM (At The Market sales of stock) in most years. Dilution has been considerable in recent years. Starting with 62.1 million shares at the start of 2015, EQIX now has 89.4 million, an increase of 44% in five years! This has three basic issues:

- The company has to grow income/AFFO much faster to offset this dilution
- The cash needs are growing as all these shares require a cash dividend
- This is a REIT adding new capacity to report growth to keep the stock high enough to be a currency – which requires more spending and more shares being issued.

	2020	2019	2018	2017	2016
Dilution from Stk Comp	0.9%	0.9%	1.2%	1.1%	1.4%
Dilution from ATM	0.5%	1.1%	0.9%	1.1%	0.0%
Dilution from Issues	3.0%	3.7%	0.0%	8.5%	14.2%
Total Dilution	4.4%	5.7%	2.1%	10.7%	15.6%
AFFO	$2,189	$1,931	$1,659	$1,437	$1,078
AFFO Growth	13.4%	16.4%	15.5%	33.3%	29.6%
AFFO per Share	$24.76	$22.80	$20.69	$18.53	$15.23
AFFO per Share Growth	8.6%	10.2%	11.6%	21.7%	7.1%
Dividends Paid	948	836	739	622	500
Dividend Growth	13.4%	13.2%	18.8%	24.4%	-4.2%
Dividends per Share	$10.64	$9.84	$9.12	$8.00	$7.00
Div. per share growth	8.1%	7.9%	14.0%	14.3%	-60.5%
Stock Compensation	$311	$237	$181	$176	$156

We do not think EQIX should add back stock compensation as a non-cash expense. The growth in total dividend outlay has been spectacular. In 2015, EQIX paid special dividends too and spent $521 million to pay shareholders $17.71 per share. The current dividend will cost $1.015 billion and amount to $11.48 per share.

14% of AFFO is adding back stock compensation and 11% of adjusted EBITDA is adding back stock compensation. EQIX reports constant currency growth with acquisitions of 7%-8%.

Without acquisitions, organic growth may be 4%-6%. The total dividend outlay is growing 2-3x that rate. When the stock is strong, everyone wants it. If it falls, people may want cash wages and cash for deals instead. It's easy to make a case that hiccups in EQIX's growth mechanism could derail the heavy issuance of stock plan.

Several Reasons We Consider AFFO Overstated

AFFO is a REIT metric that is supposed to approximate free cash flow for the current company without growth. It excludes growth capital spending but estimates a recurring maintenance capital spending figure. Unlike EBITDA, it does take into account interest expense and taxes. We see several other items that should likely be adjusted for that would lower AFFO:

- Principal payments on finance leases noted above are over 5% of AFFO and had they been viewed as operating leases would have seen the full payment lower net income.

- Stock compensation is 14% of AFFO. EQIX adds it back as a non-cash item. However, we note that EQIX is paying ever-higher dividend outlays due to the higher share count and diluting all shareholders, which impacts even employees. We believe that stock compensation represents pay to employees who would likely demand even larger amounts in actual cash wages if they were not giddy to participate in stock appreciation.

- The recurring capital spending is actually going down! This is a company that has seen its PP&E jump over 50% since 2017 and it is tech-oriented. Yet, recurring capital spending is down:

	2020	2019	2018	2017	2016
recurring Cap Ex	$161	$186	$203	$168	$142
Net PP&E	$14,503	$12,153	$11,026	$9,394	$7,199
% of PP&E	1.1%	1.5%	1.8%	1.8%	2.0%

  We'd argue that 2% may be too low indicating a 50-year life for assets, but it's now 1% only a few years later. 3% would be a 33-year life and we will adjust for that below.

- It's one thing for a company to make an occasional acquisition and argue that it's a one-time event. It's another when making deals is a key part of the business model. EQIX spent nearly $8 billion on purchases in the last five years. Yet, AFFO ignores the depreciation and amortization of these deals. It further adds back all the transaction costs and integration expenses. It ignores impairments too. Literally, these deals add to revenue and income but cost nothing more than interest expense for the financing. And

to the extent EQIX paid with stock, which it has, the cost of that capital even as the dividend is ignored. At a minimum, we think transaction costs, integration, and impairments are recurring and should not be added back to AFFO.

- On interest expense, EQIX capitalizes part of it and doesn't even record all of the cash interest being paid. We adjusted for that:

	2020	2019	2018	2017	2016
AFFO per EQIX	$2,189	$1,931	$1,659	$1,437	$1,078
Less Cap Lease payment	$115	$127	$104	$94	$114
Less Stock Comp	$311	$237	$181	$176	$156
extra CapX to 3% of PPE	$275	$179	$128	$114	$74
Less Acq. Costs	$56	$25	$34	$39	$64
Less impairments	$7	$16	$0	$0	$8
Less Cap. Interest	$27	$32	$20	$23	$13
BTN AFFO	$1,399	$1,316	$1,192	$992	$649

	2020	2019	2018	2017	2016
AFFO per EQIX	$2,189	$1,931	$1,659	$1,437	$1,078
BTN AFFO	$1,399	$1,316	$1,192	$992	$649
% lower	-36%	-32%	-28%	-31%	-40%
Dividend	$948	$836	$739	$622	$500
Dividend payout	68%	64%	62%	63%	77%

EQIX can still fund the dividend under some more realistic views of what actual free cash flows are, but it is much tighter than the 43% payout under its definition of AFFO.

We also want to highlight two other items that impact cash from operations and AFFO – capitalized costs and installation revenue. The costs consist of commissions owed, marketing, and incentives given to sign a contract. EQIX capitalizes these costs and amortizes them over 5-years. Installation revenue is considered non-recurring and consists of payments received up-front for a contract and are listed as deferred revenue and recognized as revenue over the life of the contract.

In cash flow, these payments can be lumpy – adding cash upfront for installation and also paying commissions on new contracts. They would be recognized in this lumpy manner and the smoothing impact of amortization that impacts income would be adjusted out for cash flow. For AFFO, EQIX says that adjustments it makes in this area are designed to isolate the cash impacts of these items vs. what is reported on the income statement. We will give them some kudos for trying to recognize these issues even though it remains a lumpy part of AFFO. It also consists of fairly small adjustments. We know finance lease payments are 5.3% of AFFO at $115 million.

The net impact of the capitalized costs and deferred revenue for installations were -$35 million in 2020 and -$30 million in 2019.

YUM! Brands, Inc. (YUM)
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 YUM with a 4- (Acceptable) rating.

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

Summary

YUM beat forecasts for 4Q20 by 14-cents and posted $1.15 in adjusted EPS. The adjustments were only 7-cents, of which 70% was related to a charitable contribution. We would quibble with 1.5 cents related to the early retirement of some employees and accelerating some issues for Pizza Hut as not being one-time. For the past four quarters, YUM beat by 60-cents with 68-cents in adjustments – the largest being an impairment for Habit Burger.

The biggest help was releasing tax valuation allowances in 4Q that drove the tax rate to 5.7%. For the year, we saw allowances helped by $22 million, and adjustments to deferred tax items at both federal and state levels were $17 million. Together, those two items were worth 13-cents in EPS during the year, and it does appear that helped 4Q more than other periods. There were another 9-cents in taxes added back in 2020 for transferring intangible assets within the company. Guidance is for a 21%-23% tax rate so we don't expect this source of EPS to continue. YUM also realized 3-cents from bad debt expense coming in $12 million below 2019 and 7-cents from a $26 million swing in advertising royalties not collected in 2019 to a credit in 2020.

Overall, YUM carries more debt than it should in our opinion at 5.2x EBITDA. It has also franchised 98% of its properties so that external source of cash should be much smaller going forward and that along with borrowing drove share repurchases to help past EPS growth.

What is strong?

- YUM is largely complete on its refranchising process. This leaves it a business that largely collects royalties and should see slow steady growth. The dividend may consume over 70% of free cash flow in 2021 vs 45% the last two years but appears sustainable.

- EBITDA should recover in 2021 with sales. YUM will need to ramp up marketing but is guiding to higher revenues leveraging G&A expenses. The debt at 5.2x EBITDA is expected to be at 5.0x or lower by 2Q21 with the higher EBITDA.

What is weak?

- Share repurchases fueled recent incremental EPS growth of as much as 10%-13%. We do not think YUM can afford to buy stock at those same rates. It paid for it with proceeds from refranchising stores and that process now covers 98% of stores. It further paid for the stock repurchases by borrowing and debt is now over 5x EBITDA.

- YUM may actually need to spend $200-$300 million on share repurchases just to offset share dilution from stock compensation. Even that level of spending looks tight as the company is forecasting a rise in capital spending and the dividend was raised.

- YUM had a positive $300 million swing in cash flow in 2020 by drawing down working capital. Now that will need to be rebuilt as it funds higher advertising in advance and collects from franchisees on a lagging basis. It expects higher capital spending too.

- We believe there will be a widening divergence between EBITDA and free cash flow in 2021 making it tougher to count on growing its debt load for another year. It also points to some aggressiveness in EBITDA as capital spending exceeds depreciation effectively making depreciation a cash expense. Also, there are areas of franchising where YUM collects cash payments upfront, which it spent already – but is recognized as revenue over time as non-cash income that becomes part of EBITDA.

What to watch

- YUM's overall plan can work – some organic revenue growth at the restaurant level boosting royalties to YUM and thus higher cash flow and EBITDA. It will then boost debt

to 5.0x EBITDA again and use that and free cash flow to pay dividends and repurchase stock.

- Investors should watch how long it takes actual free cash flow to start rising again. Ultimately, that's what needs to be available to cover the debt. We do not think business at usual starts up again for YUM in 2021. It has to overcome a higher dividend outlay, higher capital spending, working capital being rebuilt and advertising outlays being prepaid.

- Items like cutting bad debt reserves and tax allowances, and even minor drops in YUM's own advertising helped out results in 2020. We think the company essentially still posted EPS beats ahead of these small boosts to income. However, it is tough to make a case that any of those items do not become neutral at best in 2021 or a headwind at worst.

Supporting Detail

Cash Flow Does Not Support YUM's Past EPS Growth

	2020	2019	2018	2017	2016
Cash from Opers.	$1,305	$1,315	$1,176	$1,030	$1,248
Cap. Exp.	$160	$196	$234	$318	$427
Free Cash Flow	$1,145	$1,119	$942	$712	$821
Acquisitions	-$202	$0	-$266	$0	$0
Refranchising Cash	**$19**	**$110**	**$825**	**$1,773**	**$370**
Cash for stock	$962	$1,229	$1,501	$2,485	$1,191
Dividends	$566	$511	$462	$416	$744
Stock Repurchases	$239	$815	$2,390	$1,960	$5,403
Cash +/-	$157	-$97	-$1,351	$109	-$4,956
Net shares repurchased	0	6	26	23	65
wgt avg shares o/s	307	313	329	355	400
EPS Growth from Repo	1.4%	3.7%	9.8%	12.5%	13.0%

YUM should get some bounce in net income in 2021 as operations do not have Covid restrictions like in 2020. There are some headwinds and tailwinds too for items like taxes and working capital items in our view that may offset some of that. We think investors should focus on four other major things here:

- Guidance is for capital spending of $250 million in 2021, which is a $90 million headwind on free cash flow.

- Refranchising cash is only expected to be about $50 million in 2021 and YUM has already franchised 98% of its stores.

- The cash dividend is now $600 million so that is another $34 million headwind

- Even at the height of refranchising, YUM was still outspending that cash and borrowing billions more to fund repurchases. Net debt is $10 billion now and exceeds YUM's target of 5.0x EBITDA. That's simply not a source of additional cash to tap now.

Historically, YUM was picking up 10%-13% of EPS growth from hefty repurchases. The stock now trades for over 25x EPS and growth may more closely mirror sales growth at the underlying restaurants which is mid-single digits – with some easy comps for early 2021, which should help further in the short term. It is also worth noting that employees receive 2-3 million shares of stock per year via stock compensation plans. With the stock over $100, YUM has to spend $200-$300 million on stock repurchases to hold the share-count flat.

Cash Flow May Diverge Negatively from EBITDA in 2021

Investors understand that YUM earns a percentage of sales from franchised properties as well as an advertising cooperative payment that is also a percentage of franchisee sales. People would also not be surprised that with total sales declining in 2020, the amount of fees paid to YUM also declined.

Under the accounting policies, YUM books these revenues and bills for them monthly. Thus, the revenues become part of earnings and EBITDA as they become receivables, but the cash flow recognition lags until the receivables are paid:

- Franchise fees from the 10K: *"Continuing fees represent the substantial majority of the consideration we receive under our franchise agreements. Continuing fees are* ***typically billed and paid monthly*** *and are usually 4% - 6% for store-level franchise agreements."*
- Advertising fees from the 10K: *"We have determined we act as a principal in the transactions entered into by the advertising cooperatives we are required to consolidate based on our responsibility to define the nature of the goods or services provided and/or* ***our commitment to pay for advertising services in advance of the related franchisee contributions****. Additionally, we have determined the advertising services provided to franchisees are highly interrelated*

with the franchise right and therefore not distinct. Franchisees remit to these consolidated advertising cooperatives a percentage of restaurant sales as consideration for providing the advertising services. As a result, revenues for advertising services are recognized when the related restaurant sales occur based on the application of the sales-based royalty exception within Topic 606. ***Revenues for these services are typically billed and received on a monthly basis.”***

What this means is 2019 had higher figures for both royalties than 2020, $2.66 billion vs. $2.51 billion for franchise revenues and $1.39 billion vs. $1.33 billion for advertising. That also means since there is a lagging impact on cash flow, YUM collected more cash in 2020 than it reported in revenues from these items. This could be seen in cash flow through the working capital items:

	2020	2019	2018
change in A/R	$62	-$56	-$66
change in prepaid	$8	-$8	$0
change in A/P	$128	-$36	-$68
Working Capital change	$198	-$100	-$134
Cash from Opers	$1,305	$1,315	$1,176

There was essentially a positive $300 million swing for cash flow in 2020 from 2019 due to working capital being liquidated. We think that will reverse in 2021 and become a headwind. In fact, it may be worse because the advertising is paid in advance by YUM and collected on a lagging basis and the figure should be larger in 2021. The company seldom has more than $1.2-$1.3 billion in cash from operations so rebuilding working capital could be a sizeable drain on that figure. At the same time, cash flow is getting hit by this change, EBITDA of just over $2.0 billion will be rising as sales recover against negative comps. It is also worth pointing out that YUM deferred collection of about $60 million in royalties from franchisees in 2Q20. However, less than $1 million remained outstanding at the end of 2020 so that source of cash flow also came in already in 2020.

It is also worth noting two other areas where EBITDA may be inflated vs. Cash Flow:

- **Upfront franchise fees are often collected when a new franchise agreement is signed. Cash comes in and YUM amortizes the payment into revenue over the life of the agreement.** We don’t have an issue with that policy at all. But, given that 98% of the stores are now franchised, the cash was received (and spent). This is now a non-cash source of revenue that is inflating EBITDA, where the base of the calculation starts reported income.
- **Capital spending exceeds Depreciation and Amortization in most years and 2021 should see this again given guidance for $250 million in capital spending.** This is not a bad thing for YUM in our view. But it does point to depreciation and amortization

being a necessary cash expense and since EBITDA does not record any outflow in this area, we would view it as inflated:

	2020	2019	2018
Depreciation & Amortization	$146	$112	$137
Capital Spend.	$160	$196	$234

We understand what YUM wants to do. Grow sales at restaurants, add more restaurants and have that produce a growing EBITDA figure for YUM. That would enable it to borrow more money and keep debt at 5x EBITDA while repurchasing more stock. When we look at 2021, we simply think that plan needs to be on hold because we believe actual cash flow that does support the debt may well decline this year.

Agilent Technologies, Inc. (A)
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 A with a 5+ (Strong) rating.

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

Summary

Agilent reported adjusted EPS of $1.06 in the 1/21 quarter which was 16 cps ahead of the consensus estimate. We saw no significant unusual benefits to the quarter and consider it a relatively high-quality beat.

While we do not like the typical adding back of intangibles amortization to non-GAAP results, A does not fit the typical serial acquirer mold which reduces our level of concern. Otherwise, we consider the company's accounting to be fairly straightforward and high quality.

What is weak?

- A has made acquisitions in the past although we would not label it as a serial acquirer based on the activity of the last few years. The last major deal was the $1.17 billion acquisition of BioTek in which roughly half the purchase price was assigned to goodwill (not amortized) and half to intangible assets. The company adds back amortization of acquired intangibles to its non-GAAP earnings which amounted to about 15% of trailing 12-month adjusted income before taxes. Amortizing its goodwill balance over 40 years would reduce profits by another 7%. These amounts are not as large as some companies we follow but are still materially overstating non-GAAP results, in our opinion.

- The non-GAAP tax rate fell to 14.75% from 15.5% last year. This added a little over a penny to EPS growth in the 1/21 quarter. The company is forecasting a 14.75% effective

rate for FY 2022 so the boost to EPS growth from a lower rate should fade after the next couple of quarters.

What is strong?

- A's revenue recognition policies are very straightforward. Its equipment, consumables, and even most of its software licenses transfer to the customer at the point of transfer of control to the client. Service and extended warranties are billed upfront and recognized over the contract term on a straight-line basis. This results in a relatively low deferred revenue balance and little subjectivity in the pace of recognizing revenue. Deferred revenue days run about 25 days of sales and have tracked fairly consistently.

- The company has determined that certain sales incentives meet the requirements to be capitalized under ASC 606. However, it does not disclose these amounts, saying that the change in total capitalized costs are immaterial to results.

- A positive mark for the company's acquisition accounting is the lack of any meaningful write-offs of intangible assets in the last few years. There have been no goodwill impairments in the last three years, only $21 million in impairments of purchased intangibles, and a $90 million write-down of in-process R&D associated with the shutdown of its sequencer development program.

- The typical valuation of uncertain tax positions was the only item cited as a critical audit matter by the company's auditor which is a testament to the simplicity of A's accounting.

What to watch

- As noted above, A has made multiple acquisitions in the past. However, we would not label the company as a serial acquirer as it has not made a large deal since 2019 and its net debt level typically runs below 1x EBITDA. However, management indicated on the conference call that it is looking to increase its M&A activity. We will be watching for any change in direction and could reassess our rating if reckless acquisitions become a habit.

- A reports an "other income (expense)" line on the income statement below the operating income line. This amount typically includes items such as loss on debt extinguishment and derivative costs and gains This amount can fluctuate materially and it should be reviewed quarterly for any unusual movement that is not adjusted out of non-GAAP results. In the case of the most recent quarter, other income fell to $3 million from $21

million last year. However, the major drivers including a $5 million loss on early extinguishment of debt in the 1/21 period and a $16 million gain from the change in the value of equity investments in the 1/20 period were adjusted out of non-GAAP results.

- The company maintains a warranty reserve which we will monitor quarterly. However, the reserve and associated provision expense has tracked relatively in line with revenue with fluctuations not meaningfully impacting earnings in the last several quarters.

- We note that the company's "other current asset" account jumped in the 1/21 quarter to 18.5 days of sales after tracking consistently in the 13 to 15-day range for the last several quarters. We are uncertain of the increase but do observe that the company's capitalized costs to obtain contracts are included in that account. As we noted above, the company does not disclose detail on those capitalized costs as it deems them immaterial. At this point, we are not overly concerned but will monitor for a sustained increase in the other current asset account which could indicate the delayed recognition of expenses.

- A reports regular charges on its cash flow statement for charges for excess and obsolete inventory. These amounts have remained fairly stable, falling between $4-$10 million per quarter over the last two years. The company also reported sales of previously written down inventory in the costs and expenses discussion of its 10-K. These amounts have also remained consistent over the last three years ranging from $6-$8 million annually. These trends should be monitored for signs of any unusual boost to profitability from selling inventory with an artificially low cost basis.

Starwood Property Trust (STWD) Earnings Quality Update
March Investor Day

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

We are maintaining earnings quality coverage of STWD with a 5+ (Strong) rating.

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

Summary

After the 4Q20 earnings, STWD announced that it would soon have a virtual call and presentation describing its business in more detail. That happened in March and delved into the company's rationale behind getting into some of its diverse portfolio of businesses, how they view risk, and operate each as well as in tandem with other units. Some of this has been discussed in our other updates. This includes having floating-rate loans with floors so that the impact of falling rates is limited, but STWD still enjoys higher earnings as rates increase. Also, the company owns property directly, which effectively adds duration to the portfolio at the same time it enjoys rising rental income. But there was some additional information discussed that we believe illustrates the lower risks at STWD than other mortgage REITs and makes us continue believing that this company should do well and reward shareholders over various credit and interest rate cycles.

What is strong?

- **Lending standards on commercial mortgages have improved considerably since 2009, which are what go into securitizations.**
    - Prior to the GFC, a typical securitization had 70% Loan to Value mortgages, it included industries like senior living, casinos, and subordinated loans, the

minimum debt service was 1.05-1.35x. Also, rents were assumed to rise over time and vacancies assumed to be filled as well.

  - Since 2009, a securitization is only 60% Loan to Value and does not include troubled asset classes. **Only in-place rents are looked at and those are marked down to market in the event of a sublease. Tenant credit is considered as well** as the timing of lease renewal. Minimum debt service is 1.35-1.87x.

  - Prior to the GFC, securitizations had little if any cash reserves and lower average debt coupons.

  - Since 2009, securitizations have cash reserves and a guarantee from the sponsor.

  - STWD goes a couple of steps further on its securitizations by hedging the interest rate risk and locking in the credit spread as well as stress testing each loan to determine what helps or hurts the situation.

  - As the securitizer, STWD is required to own a B-piece of 5% of the pool for a minimum of 5-years. The securitization allows STWD to recycle its capital to make more loans and it views the investment in the B-piece as an attractive deal. As the builder of the portfolio, STWD can kick out loans from the pool, split loans between pools, require credit enhancement on specific loans all in the name of producing lower risk.

- **Starwood's close watch of each of these loans and their subsequent performance plays to its business of special servicing too – LNR.** Special servicing is a counter-cyclical business that deals with loans and securitizations that run into problems. Often, STWD is willing to opportunistically buy B-pieces of other securitizations which will also lock in LNR as the special servicer.

  - Each loan in the portfolio can be reassessed and weak performing loans underwritten again on better terms where needed.

  - LNR typically invests in workouts and almost always negotiates a higher equity commitment from the borrower.

  - It can also get paid by completing a workout or liquidating the property – a lagging payment compared to trust fees or borrower fees.

- Another unit at STWD also invests in deals provided by the Special Servicer for turnaround plays in real estate. Having LNR see many situations, allows STWD to be selective and knowledgeable about what may be coming.

- These types of situations may add some long-term growth potential and future gains for STWD after Covid.

- **Liquidity remains very strong at STWD and it does not have nearly the same risks of traditional mortgage REITs that rely heavily on warehouse lending to finance their investments.** There are two downsides to warehouse lending: the duration doesn't necessarily match and the loans can often be called if the collateral is marked down. STWD counters this with a more diverse source of debt with longer terms.

  - Normally, STWD holds $250 million in cash on hand. This is a drag on earnings but helps liquidity. Cash was over $700 million at the end of 4Q, so putting that back to work is worth about 3-cents in EPS per quarter.

  - Half its total capital is off-balance sheet financing and equity.

  - 45% of debt is either unsecured or off-balance sheet.

  - 62% of debt has no margin calls and 75% has no margin calls or only calls based on credit issues.

  - The life of liabilities of secured liabilities is 50 months vs. 41 months for the mortgage assets tied to them. That reduces refinancing risk as the mortgage rolls over. This also highlights STWD's use of A-Notes as financing over warehouse lines. For a typical commercial mortgage, it is 75% borrowed with 25% equity. STWD splits the 75% loan into an A-tranche of 56% and a B-tranche of 19%. It will then borrow against the A-tranche with A-Notes.

  - STWD has $7 billion in liquidity now plus $3 billion in unencumbered assets. The goal going forward is to continue to boost unencumbered assets with more issuances of unsecured debt and securitizations to move debt off the balance sheet.

  - We believe all of this activity continues to point to STWD's dividend being safe.

What to watch

- The securitizations allow STWD to recycle capital and generate/buy more commercial mortgages and non-qualified residential loans. This also effectively removes the loans and borrowing off the balance sheet and it can avoid mark-to-market issues on those portfolios. However, STWD has to consolidate the securitizations with GAAP, which effectively makes the debt and asset totals look higher with the VIEs included.
    - The CMBS – by owning the B-share STWD has to consolidate the deal.
    - The non-QM residential – by having kick-out rights on loans in the securitization, STWD has to consolidate.
    - STWD's on-balance sheet leverage is 2.18x Debt/Equity. Adding in the securitizations, it rises to 3.49x. However, the securitizations are non-recourse to STWD.
    - The consolidation is required by GAAP, but the real leverage is lower. Also, by using securitization and its own underwriting and monitoring prowess – STWD can effectively control more loans and diversify away from risk even more.
    - Also, holding a portion of the B-share tier can provide STWD with a double-digit return and with its servicing business involved, it can react quickly to preserve the credit for the full securitization.

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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