BEHIND THE NUMBERS
Quality of Earnings Analysis
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Mondelez (MDLZ) Earnings Quality Update

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 MDLZ with a 2- (Weak) rating.

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

Summary

MDLZ beat forecasts by 8-cents in 1Q21 and had a 1-cent headwind from a slightly higher tax rate. Taking more pricing than cost inflation added $102 million to operating earnings in 1Q and provided 6-cents in EPS. We doubt that level of excess pricing gain can continue and that was the largest bump in many quarters. It's worth noting that despite that much excess pricing, MDLZ posted a flat gross margin. We believe the company also benefited from flat accruals on marketing sequentially and while Easter was in 2Q, it occurred on April 4 and thus some revenues were likely pulled into 1Q21.

What is strong?

- MDLZ has seen more initial stocking demand into new stores in China and India. This is giving the company some more market share. Going forward, sales should at least hold at those levels. And, MDLZ has a very easy comp in that area for 2Q.

	1Q21	4Q20	3Q20	2Q20	1Q20
Asia/ME/Africa Vol	7.9%	-0.8%	1.8%	-4.6%	0.9%

What is weak?

- Real evidence that COVID demand was short-lived and is rapidly returning to normal is in the biscuit category. Biscuits are the bulk of North American sales. As noted in prior updates, MDLZ had 11% biscuit growth worldwide and 24% in North America in 2Q20. By 4Q20, Biscuits were up less than 7% and rose by only 3.4% in 1Q21. North American growth has resumed its history of weak volume gains that move inversely with attempts to boost price. The company will argue it had a tough comp in 1Q, which is true, but the comps are not going to be easy for some time. For 1Q21, North American volume growth was -2.8%. For much of 2019 and earlier, volume growth at this unit was negative anytime MDLZ sought to take pricing greater than 1%.

- Organic Growth of 3.8% in 1Q is overstated by 90bp in our view due solely to inflation in Latin America. This unit is now less than 10% of total company sales and posting negative volume changes. Yet, its 10.1% price hike was the difference between MDLZ reporting 3.8% growth instead of 2.9%. More importantly, the negative FX hit for Latin America was -15.1% so the unit actually posted huge negative growth overall and this situation has been happening for years so it's not a COVID issue.

- Trade promotions and incentives are reported as reductions to sales. Marketing accruals were flat sequentially and have stalled the last two quarters. Management is touting higher marketing but also making comments about being more focused on where it spends and seeking higher ROI. We think promotions are not growing and that is allowing net sales to increase and also help EPS.

- Gross margin is flat despite pricing gains exceeding cost inflation by $102 million in 1Q21. In the past, MDLZ has had a difficult time taking large amounts of excess price without it costing it volume. The $102 million was 6-cents in EPS and was the largest bump in many quarters. What if inflation takes some of that back? What if gross margin actually declines? 20bp of gross margin is about 1-cent in quarterly EPS.

What to watch

- Working capital appears in line with pre-COVID levels, except for payables. Normally 1Q is one of the lower figures for the year and 2Q is the highest.

MDLZ working capital	1Q21	4Q20	3Q20	2Q20	1Q20	1Q19
Days Payable	136.1	126.0	127.5	139.3	119.1	128.7
Days Inventory	56.3	54.6	64.7	69.1	52.3	60.6
Days Receivables	33.5	28.7	34.1	30.6	35.8	38.8
Days Receivables Sold	11.4	9.5	10.7	10.6	11.4	11.3

What is concerning about this is MDLZ's cash flow guidance may get some pressure from working capital. For 1Q21, MDLZ generated -$443 million from working capital for operating cash flow. That is better than 1Q20 when receivables spiked with the start of COVID and MDLZ posted a -$740 million headwind for cash flow. But 1Q19 was -$743 million too. For the latest quarter, MDLZ had a bigger help from payables rising. Normally, that occurs in 2Q so some of that may have been pulled forward. It is worth watching to see if cash flow is more subdued y/y for 2Q21.

Supporting Detail

Latin American Price Increases Are Adding about 100bp to Organic Growth

Sales growth is skewed by Latin American price increases. MDLZ reported 3.8% organic growth based on 2.3% price increases and 1.5% volume growth. Latin America reported a 10.1% price hike and the market is poor as volume growth was -2.9%. Because of massive inflation in the region, MLDZ is taking a sizeable hit on FX of -15.1% that wipes out all of the Latin American organic growth.

By all accounts, Latin America is probably the weakest market in the world. That is not just 2021, it's been that way for some time. Here are some recent results from that region:

Latin American Growth	% Total Sales	Vol	Price	Org. Growth	FX	Real Growth
1Q21	9.2%	-2.9%	10.1%	7.2%	-15.1%	-7.9%
2020	9.3%	-7.5%	7.7%	0.2%	-18.1%	-17.9%
2019	11.7%	-2.1%	9.9%	7.8%	-13.5%	-5.7%
2018	12.3%	-2.6%	6.2%	3.6%	-13.8%	-10.2%

As a percentage of total MDLZ sales, Latin America is getting smaller and smaller. It has been reporting negative volume – even during COVID, the volume decay tripled. The hefty price hikes are giving the illusion of strong organic growth, but the FX hit more than wipes out the price hikes. What is problematic is MDLZ's total organic growth is being overly skewed higher by this distressed situation:

MDLZ Org. Growth	Vol	Price	Org. Growth	w/o L.A Price
1Q21	1.5%	2.3%	3.8%	2.9%
2020	1.8%	1.9%	3.7%	2.9%
2019	1.9%	2.2%	4.1%	2.9%
2018	1.1%	1.3%	2.4%	2.2%

If we only strip out the price increase from Latin America (less than 10% of total sales) which is misleading because of the negative FX problem – it erases basically 100bp off MDLZ's organic growth rate.

Trade Promotions and Incentives Reduce Revenue – Those Items Are Another Headwind

Trade promotions and sales incentives are another headwind for sales growth. These are recorded net of sales. Thus, with COVID when there was no need to run in-store promotions, incentives, or coupons at normal levels, sales did not have as large of a drag from these programs. That alone lifted sales in 2020 quarters and likely still into 2021. We are going to isolate price to show some of the impact of lower trade promotions cutting revenue:

Price Gains AMEA	1Q	4Q	3Q	2Q
2020/1Q21	2.9%	3.8%	2.4%	1.5%
2019/1Q20	1.3%	2.6%	1.7%	1.9%
2018/1Q19	1.1%	1.1%	1.5%	2.7%
Price Gains Europe				
2020/1Q21	0.9%	-0.6%	-0.2%	-0.8%
2019/1Q20	0.4%	-0.5%	0.3%	0.3%
2018/1Q19	0.0%	-1.1%	0.5%	-0.7%
Prices Gains Nor. Am				
2020/1Q21	0.5%	2.1%	2.1%	3.6%
2019/1Q20	1.2%	1.9%	1.9%	3.5%
2018/1Q19	2.0%	2.9%	1.2%	0.6%

MDLZ claims it is starting to boost trade promotions again along with other forms of advertising. It sounds like more of the new spending is going toward e-commerce and the company has talked about boosting ROI for other forms of marketing which we interpret as selectively spending. We still think going forward, there will be more pressure on pricing as trade promotions increase. When we look at accrued marketing, it has risen y/y. However, it is no longer rising sequentially.

Accrued Marketing $	1Q	4Q	3Q	2Q
2020/1Q21	$2,136	$2,130	$2,028	$1,804
2019/1Q20	$1,848	$1,836	$1,745	$1,638
Accrued Mrk % Sales				
2020/1Q21	29.5%	29.2%	30.4%	30.5%
2019/1Q20	27.6%	26.6%	27.5%	27.0%

It appears to us that MDLZ may not be seeing this ratio rise going forward and may actually decline a bit more. The dollar amount saw the largest jump from 2Q20 to 3Q20. Since then, the recovery in advertising and trade promotion appears more muted.

How Long Can MDLZ Take Pricing in Excess of Inflation? Gross Margin Is Already Pressured

We also have seen MDLZ taking pricing in excess of commodity inflation and this continued in 1Q21. Our view is customers watch the inflation data also and are also stocking private-label goods at lower prices. This is something that should even out over time. What is a red flag is MDLZ is NOT getting gross margin gains from this:

Price/Cost change	**1Q21**	**4Q20**	**3Q20**	**2Q20**	**1Q20**
Price Hikes	$151	$127	$129	$120	$119
Cost Inflation	-$49	-$121	-$63	-$102	-$108
Net boost	$102	$6	$66	$18	$11
y/y Gross Margin chg.	0 bp	-80 bp	20 bp	-90 bp	-20 bp
y/y Oper Margin chg	140 bp	40 bp	70 bp	-80 bp	-20 bp

There are three other points to consider here. In 2Q and 3Q in particular, retailers were low on product and needed to refill shelves. That type of demand may have been less price-conscious and allowed MDLZ to boost prices faster than warranted. We doubt that situation repeats itself.

Next, during this same time, MDLZ culled 25% of its SKUs in 2Q and 3Q. We think SKUs come and go all the time, but 25% was a large number during 2020. Normally, SKUs being eliminated are marked down to clear the shelf space for new product. We believe COVID allowed that product to be sold at full price. In fact, much of it may have disappeared before MDLZ formally discontinued them.

Third to consider is the timing of Easter and Chinese New Year. Easter was technically in the 2Q this year, but it was April 4th. Much of the consumer buying for Easter likely happened in 1Q which helped sales growth and the Chinese New Year was disrupted in 1Q20 but had far fewer issues in 2021. So, we think there were some additional sales in 1Q21 that should have leveraged gross margins.

Thus, with all those extra sources of demand and taking pricing in excess of cost inflation – MDLZ is not seeing its gross margin rise. What happens as sales level off further? What happens as trade promotions return to normal and become headwinds on sales? MDLZ is making up for that with SG&A cuts. COVID costs are falling at this point, but that eventually runs out. Also, we noticed the largest SG&A contributions came in the last two quarters when marketing accruals were flattening out.

International Business Machines Corporation (IBM)
Earnings Quality Update- 3/21 Qtr.

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

We maintain our earnings quality rating on IBM of 2- (Weak).

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

Summary

IBM's non-GAAP EPS of $1.77 beat estimates by 12-cents in 1Q21. The non-GAAP EPS was already lower by 7-cents y/y from 1Q20 so investors were not expecting too much. We found several areas of non-recurring items that were material benefits to 1Q21 results and account for far more than the EPS beat. Now that we have the 10-Q, we can identify these issues and the tame ones like cutting bad debt expense and marketing along with some apples-to-oranges cost comparisons that total 27-cents in EPS in our opinion. There is another 58-cents from dumping a large amount of the recurring workforce rebalancing into a 4Q charge plus 37-cents from acquisition items being added back that allows IBM to keep R&D expense off the non-GAAP income statement.

IBM did not expand guidance after its reported beat. It still expects to produce free cash flow of $11-$12 billion before $3 billion in cash costs for restructuring. There is a $6 billion dividend, the company has already spent $1 billion on acquisitions and already reduced capital spending by over $200 million in the 1Q. There are still financing receivables to sell to offset the cash spending.

- IBM picked up 8-cents in both non-GAAP and GAAP EPS by reporting a credit of $29 million for bad debt expense in 1Q21 vs. a $56 million charge in 1Q20.

- IBM added 8-cents more in both non-GAAP and GAAP EPS by spending $76 million less on advertising and promotional programs y/y. These expenses fell in 2020 after COVID started and we would expect a headwind for IBM going forward.

- **We noted in the original report that IBM had taken $11 billion in charges for workforce rebalancing over the years.** Our concern was the spin-off may cause charges of this nature to start being considered restructuring items and be added back as one-time in nature. This happened in 4Q20 with a large part of $2 billion going to workforce rebalancing and the street ignored it. However, now in 1Q21, the ongoing workforce charges that have been happening for over 15 years dropped to $146 million from $721 million in 1Q20. **Both non-GAAP and GAAP EPS had these charges and the drop added 58-cents to 1Q21 EPS.** The huge workforce rebalancing in 1Q20 resulted in a loss at GTS – the business being spun-off and Systems. The much lower charge in 1Q21, allowed both units to post a profit.

- **What was not quantified is IBM also benefited in 1Q21 from lower travel costs and lower COVID costs as well.** For the talk about IBM cutting costs, we see that SG&A costs were essentially flat y/y if we adjust for the items above. They came in at $5,174 million vs. $5,212 million and lower COVID and travel costs may have accounted for that. Going forward, there should be a tailwind from COVID but travel should increase. Lower travel was listed as a key reason the GBS unit had a better margin.

- **R&D continues to be acquired by IBM. We noted in the original report that IBM has been an acquisition machine making 172 deals in the past 20 years. It added another 6 purchases since mid-December 2020 and the cost was another $1 billion in 1Q.** Of the companies acquired, IBM assigned $746 million of the $987 million cost to goodwill that will not be amortized – thus no expense on earnings. Another $114 million was assigned to developed tech and will be amortized over 3-7 years. Finally, $134 million was listed as client relationships and is amortized over 7 years. **HOWEVER – for non-GAAP EPS, IBM adds the two amortization expenses of acquisitions back. Thus, IBM is reporting largely flat R&D as amortization costs rise but are ignored.** The cash flow statement shows the cash outflow for mergers, but earnings are being elevated by ignoring the cost:

	1Q21	1Q20	1Q19	1Q18
R&D Expense	$1,630	$1,625	$1,433	$1,405
R&D % Sales *	9.3%	9.4%	8.3%	7.7%
Amort. Acquired Intang.	$453	$473	$173	$203
EPS from adding back Acq	$0.37	$0.42	$0.18	$0.17

R&D % Sales excludes revenue from Global financing and Other

This table shows the acquisition of RedHat during 2019 leading to higher total R&D spending. RedHat was spending about $600 million per year on R&D, or about 18% of its $3.4 billion in sales. **R&D was basically flat y/y in 1Q21 and down slightly as a percentage of sales. But it looks to us that non-GAAP EPS is gaining about 40-cents per quarter because IBM is ignoring the cost of buying the new technologies.**

- Direct Financing Lease business also looked out of the ordinary in 1Q21. The accounting policy changed on January 1, 2019, whereby the lessor excludes the unguaranteed portion of the residual value from the cost of inventory at the time of sale. It used to be that IBM would evaluate the residual value each year for impairments. Now, the gross profit on a direct financing lease is the sales price of the product less the cost of the inventory, which excludes the unguaranteed residual value. The 1Qs for the last three years should be apples-to-apples.

Income on Direct Fin. Leases	**1Q21**	**1Q20**	**1Q19**
Sales price	$363	$211	$149
less inventory value	$59	$76	$55
Gross Profit	$304	$135	$94
Interest income on leases	$51	$74	$79
Income on Direct Fin. Leases	$355	$208	$172

Looking at 1Q21, we can understand sales picking up. However, the cost of inventory without the unguaranteed residual value dropped noticeably. This cost of goods sold was 37% and 36% of sales in 1Q19 and 1Q20. This year it fell to 16%. We could not find an explanation for this in the 10-Q. IBM is touting that it grew its gross margin by 110bp from 46.2% to 47.3% which is $272 million. Higher revenues accounted for $81 million and the margin increase added $191 million. We think $73 million of the $191 million came from this sudden 20% increase in gross margin in new finance leases due to the drop in reported cost of goods sold. That $73 million is 7-cents in EPS.

- We know that part of the 4Q20 restructuring activities involved reworking contracts at the GTS (Global Technologies) unit. The goal was to cull lower margin areas and offer customers more future services for higher payments. In 4Q20, IBM reported that this grew gross margins at GTS by 70bp. In 1Q20, IBM said these deals grew gross margins by 60bp but the positive impacts have not been fully seen yet. We found that odd given that 1Q should have had a full quarter with most of the reworked deals and yet the gross margin gain was lower. We also think offering customers the ability to add new services and support to the deals in return for altering contracts sets up IBM and the GTS spin-off for higher costs in the future. In 1Q21, the 60bp of gross margin gain in this area added $38 million or 4-cents to EPS.

Altria Group (MO)
Earnings Quality Update- 3/21 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 MO at 3- (Minor Concern).

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

Summary

MO's 1Q21 looked like we anticipated with smoking volumes dropping 2%, an acceleration of the decay from the prior two quarters. We still believe MO was one of COVID's biggest beneficiaries as people working from home had the ability to smoke more often. Going forward the comps get tougher for smoking and that is still the primary driver of MO results. With the volume decay resuming, Adjusted EPS fell 2-cents y/y as revenue declined 4.6% for smokeable products and operating income was down 0.7%. We believe decay rates will exceed -5% during 2021. Please review last Friday's note for more details on the significance of this problem.

Also as noted last week, the menthol ban potential is becoming a bigger news item and the FDA is proposing it again. The industry will predict it will take years. We will just point out that five states have already banned menthol – Massachusetts, New Jersey, New York, Rhode Island, and California. California's ban has been delayed as the matter will be on the November 2022 ballot. In terms of cities and counties, California has 90 that have menthol bans, Chicago, 13 in Minnesota too. Early in 2021, 23 state attorneys general asked the FDA to ban menthol. The important point we think is this is not an issue starting at step one when the industry predicts it will take years to get a ban. The FDA already has numerous studies on the matter to support a ban, it has already banned other flavorings, and many countries including Canada and much of Europe have bans in place.

Finally, MO took another $200 million charge to write down the value of JUUL. It continues to avoid taking a charge on its BUD position as it remains underwater as valued on the stock market. We still expect an eventual write-down here. MO has been claiming it is a temporary decline, but this has lasted years and started long before COVID. Also, there is a very easy value to look at – the publicly traded stock price – in assessing if the carrying value is above the actual value.

Microsoft Corp. (MSFT)
Earnings Quality Update- 3/21 Qtr. Preview

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

MSFT's non-GAAP EPS of $1.95 topped the consensus estimate by 17 cps with revenue exceeding the Street's target by more than $850 million. We identified about 8 cps of unusual items benefitting the non-GAAP EPS number but results still decidedly topped estimates without them. Results from all three segments were ahead of company guidance but the market was apparently expecting more as the stock reacted negatively. Other items of note in the quarter:

- Recognized gains from equity investments added over 4.5 cps to earnings growth in the quarter.

- The non-GAAP effective tax rate was 14% which was below the company's forecast of 15%. This added about 2.5 cps to earnings in the period.

- Intelligent Cloud unearned revenue days of sales fell once again to 78 from 87 in the previous quarter and 96 in the year-ago quarter. Management continues to cite a move towards larger, longer-term hybrid cloud contracts with more of the contract billed as used. This results in less revenue deferred upfront. The remaining performance obligation, which is the total amount of revenue remaining under contract less revenue deferred continued its strong trend of growth, rising 30% YOY in the quarter. About 73% of the RPO is made up of revenue that has not been billed yet versus 67% a year ago. While the amounts under contract is definitely less certain to be realized than amounts that have been billed and deferred, this does substantiate management's claims that less revenue is being billed upfront and that future billings look strong.

- Note that the change in the company's depreciation schedule for server and network equipment that took effect in the 9/20 quarter continued to add about 7 cps to earnings growth. This benefit has one more quarter to go before it laps. Management has discussed and disclosed the benefit well so expectations should reflect the impact of the benefit disappearing.

Stanley Black & Decker, Inc. (SWK)
Earnings Quality Update- 3/21 Qtr. Preview

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

We are raising our earnings quality rating on SWK to a 4+ (Acceptable)

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

Summary

SWK reported adjusted EPS of $3.13 which was 56 cps ahead of consensus with sales over $200 million higher than expected. This was despite the fact that the adjusted effective tax rate was 20% vs. 12.5%. SWK had forecast a 15% tax rate for 2021 so we believe this higher rate could have cost the company around 20 cps versus analysts' models which makes the beat even more impressive.

In addition to the beat, the company raised its 2021 non-GAAP EPS guidance to between $10.70-$11.00 from its previous $9.70-$10.30 range. The first half of 2021 features a huge tailwind from easy comps, but these will turn very difficult in the second half of the year when results will compare to the rapid pandemic-induced DIY sales from the back half of 2020. It is beyond the scope of this analysis to assess whether management's optimistic sales forecast is achievable. Nevertheless, we are raising our earnings quality rating to 4+ (Acceptable) as the acquisition-related add-backs are declining and cash flow conversion remains strong.

We note these other items from the quarter:

- EPS was boosted by about 4 cps from a decline in provision for bad debts as a percentage of sales compared to last year's quarter in which the company built reserves at the onset of the pandemic.

- Lower warranty provision as a percentage of sales added about 1.5 cps to earnings. However, the warranty allowance as a percentage of trailing 12-month revenue remains in line with the historical trend so we are not concerned at this point. This should be monitored going forward for unusual activity.

Stryker Corporation (SYK)
Earnings Quality Update- 3/21 Qtr. Preview

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

SYK reported non-GAAP EPS of $1.93 which was 5 cps below consensus. Sales came in above consensus and the company affirmed its organic top-line growth rate for 2021 of 8-10% and actually raised its guidance range for 2021 EPS to $9.05-$9.30 from its previous range of $8.80-$9.20. Management seemed to indicate that the earnings shortfall in the quarter was related to accelerated investments in the newly acquired Wright Medial. Still, the market reacted negatively to the quarter.

We continue to see red flags which reduce our assessment of the company's earnings quality and prompt us to maintain our rating of 3- (Minor Concern):

- The adjusted effective tax rate returned to a more normal 13% from 8% in the previous quarter, but this was still below last quarter's guidance for an annual effective rate of 15.5% to 16.5%. This likely provided a 4.5 cps tailwind to the quarter versus most analysts' models.

- Acquisition and integration costs related to the November 2020 Wright Medical deal and the December 2020 OrthoSensor deal which were added back to non-GAAP results jumped to $129 million in the 3/21 quarter. This follows the $97 million added back in the 12/20 quarter. These together amounted to about 4% of the total purchase price of both deals net of cash. The size of these charges increases the chance that operational items could have been included and written back to adjusted results. We will be more skeptical if these charges remain meaningful going forward.

- As we discussed in the last review, the new acquisitions have boosted the amount of intangibles amortization added back to non-GAAP results which totaled 20% of adjusted net income for the period. This distorts adjusted results by ignoring the cost of the deals.

- On a positive note for earnings quality, the add-back of restructuring charges plummeted to $18 million which is the lowest level since 2018.

Ares Capital Corp. (ARCC)
Earnings Quality Update- 3/21 Qtr.

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

We are discontinuing coverage of ARCC and consider the EQ to be 4+ (Acceptable). We are also removing ARCC from our Focus List where is currently rated as an On Deck Buy.

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

Summary

ARCC beat by 1-cent for 1Q21 and we saw few problems. It was known that 4Q20 could not be duplicated. That quarter saw deals that were delayed during 2020 close en masse in 4Q as well as deals expected to be complete in 1Q21 pulled into 4Q20 as well.

The company still out-earned its dividend – with 43-cents of core EPS vs. the 40-cent dividend. Capital fees have recovered to normal levels as deal flow has resumed. Normally, these fees are $30-$40 million per quarter and came in at $38 million vs. $12 and $16 million in 3Q20 and 2Q20. ARCC still has $1.04 in spill-over income that it has not paid out as dividends. This should help ensure the 8%+ dividend yield as the company can always tap this support the 40-cent quarterly dividend.

We really only see one issue going forward that ARCC needs to improve – it needs to operate at a slightly higher debt/equity ratio to boost total investment income if it wants to grow further. The ratio was down to 1.06x from 1.20 in 4Q as first quarter saw a period of heavy refinancing of in the portfolio and the size of the portfolio declined slightly. The actual portfolio companies are growing and EBITDA growth was up 7% y/y and exposure remains high in growth areas such as software and medical.

With the stock above book value, ARCC's capital appreciation may be limited or it could look to acquire another BDC trading below book value and create value reworking that portfolio like it did with ACAS the #2 player in recent years.

Accounting quality is solid and beyond mark-to-market issues, there is not much that can create fireworks. It went through COVID fine and continues to see credits improve. We do not think we are adding much value continuing coverage at this point. Also, while ARCC's earnings benefit from rising rates given that most of its investments are floating rate and it has fixed much of its own financing – computer screens do not investigate that far. The computers will see a company with a high non-growing dividend and consider the stock likely to fall with rising interest rates.

Changes to BTN Focus List

Additions:

Equinix, Inc. (EQIX)

We are adding EQIX to our Focus List as a Top Sell. Earnings quality coverage of EQIX was initiated on 4/9/2021 with a 3- (Minor Concern) rating. We recommend clients read the original review for details.

Main Concerns:

- EQIX is not self-funding. It routinely runs a free cash flow deficit of $1.3-$2.0 billion after funding all 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. Organic revenue growth is 8-10% and AFFO growth is 13-16% but these are being boosted by acquisitions and new building. These figures are already being diluted by 400-600 bps from new share issuance to fund the growth. We estimate the dividend is growing 2-3 times the rate of organic growth.

- Finance leases overinflate REIT figures- AFFO would fall by over 5% if the principal portion of leases was not excluded. AFFO figures are also inflated by excluding stock comp and maintenance capex looks light at only 1.1% of PPE.

- Amortizable lives appear long which increases the risk of write-downs.

Timing:

Data Centers are a hot investment area now and EQIX is posting growth. We do not see a clear near-term catalyst to cause the stock to drop. However, we believe when the market digests the fact that the company is not self-funding, the degree of dilution it is incurring to fund growth, and that the dividend is far outgrowing the organic growth rate, the stock price could be more than cut in half.

Removals:

Ares Capital (ARCC)

As noted previously in this issue, we are discontinuing earnings coverage of ARCC as the accounting is clean and we do not feel we can add value at this price level. We consequently remove ARCC from the Focus List as an On Deck Buy.

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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