BEHIND
THE NUMBERS
Quality of Earnings Analysis
May 14, 2021

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Treehouse Foods, Inc. (THS)
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 cutting our earnings quality rating of THS to 2- (Weak) from 3- (Minor Concern).

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

Summary

THS beat non-GAAP EPS by 3-cents for 1Q21. That included adding back 4-cents in charges related to responding to shareholder activism (the first time we've ever seen that BTW). THS also added back 2-cents from the remaining inventory mark-up for the Riviana deal in 1Q.

The company also added back another huge 16-cents from COVID, which the company said came in below expectations. We are very skeptical of this as THS has now spent 75-cents of EPS on COVID – the company only earns about $2.50 pre-COVID and their COVID cost figures are rising from 9-cents in 3Q20? We are not seeing other companies reporting that percentage of earnings going to COVID planning. THS is now starting its 4th series of restructuring in just over 3-years. It added back 35-cents in "one-time" items here in 1Q.

After all the prior work of boosting prices, realigning its plants, culling SKUs, COVID demand… THS is reporting that gross margin was essentially flat and said it gained 9-cents from the "timing of lower expenses" – which sounds to us like saving on travel costs and lower marketing. Also, if there are lower marketing costs such as trade discounts and store incentives – that effectively raises the revenue figure and should help gross margin.

Note that the company is currently an On-Deck Sell on the BTN Focus List. This quarter would prompt us to move this to a Top Sell were it not for the smaller market cap and making this a potential buyout target and some investors pushing the company to sell out to a new management team.

What is weak?

- What else is in the COVID Costs? THS reported another 16-cents in COVID-related costs for 1Q21 – which, of course, it added back to adjusted EPS. That is now 75-cents that THS has added back related to COVID – which is 25%-30% of their annual adjusted EPS figure. We looked to see what they did that others are not – we aren't seeing anything different. THS built a program to talk to employees more often, office employees worked at home, they cleaned more and offered masks, and employees in the production and warehouse operations received a bonus.

  It is also worth remembering that a COVID meant THS saved money on travel and entertainment. It likely benefited from making higher sales with less marketing and advertising overall too. As noted above, THS claims it picked up 9-cents from timing issues helping it reduce costs in 1Q21.

- Another restructuring? Strategic Growth Initiatives began in 1Q21 and are expected to cost $130 million largely consisting of consulting and professional fees along with new technology to help marketing and value-engineer the supply chain. There were other restructurings to implement the IT system and exit some facilities in 1Q21. This follows Treehouse 2020 that cost $300 million, started in 3Q17, and just ended. That was designed to optimize the supply chain, cut employees, and optimize the manufacturing operation. Treehouse 2020 was already followed by Structure to Win in 1Q18. That cost $93 million and sought to cut administrative costs and fix and centralize the supply chain. Since 2017, THS has added back $8 to EPS for restructuring charges.

We have been asking what is there to show for this?

- Gross Margin is down 300bp since 2017
- General and Administrative costs are down 20-30bp since 2017
- Organic Growth was 0.7% in 2017, then -1.0%, then -5.0%, 2.7% with COVID, and now down -5.0% to start 2021.

- What else can help gross margin? THS culled lower margin SKUs in the last three years that were worth about 14% of total sales. COVID meant the shelves at the stores were cleared, and then fully restocked at full price and there should have been fewer marketing discounts, incentives, promotions required that lower net sales. THS was able to manufacture at full capacity to not only restock shelves, but also rebuild its own inventory. That should have spread fixed costs over more volume and helped gross margin. THS had a $40 million jump in volume in 4Q20 and it is now back to 68 days on its own inventory level. That is about normal of around 70 days and up from 58 days in 4Q20. With all of that, THS just posted a flat gross margin of 18.1% y/y.

  Against that, THS has higher wages and higher raw material costs. It is also spending more on shipping. THS guided to 20-30 cents of adjusted EPS in 2Q due to these pressures vs. the 36-cents in 1Q. They hope to take more pricing going forward and THS does use FIFO accounting. Their inventory turns about 6x year so they could get some recovery there, but it sounds like gross margin will weaken further before then. It may have been easier to take pricing before restocking the retailer shelves. THS has not been successful in getting price hikes since 2018, yet it noted other years like 2017-19 when commodity inflation pressured results and they did not fully recover those costs.

- Cash flow is under pressure too with inventory rising and the company benefited from selling more receivables y/y along with a greater dollar figure related to slow paying the banks who are due the cash after THS receives the payment on receivables it sold to the banks:

	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
A/R Sold	$246.7	$284.3	$226.7	$200.1	$229.8	$243.0	$196.2	$184.5	$148.7
Payables on Collections	$128.8	$202.8	$123.6	$131.3	$106.7	$158.3	$136.6	$70.5	$97.5

Cash from operations was -$5.5 million for 1Q21 vs. $68.5 million for 1Q20. For 1Q21, THS benefited from selling more receivables and holding more cash from the banks, that represents a potential headwind for cash flow going forward.

TransDigm Group Incorporated (TDG)
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 raising our earnings quality rating of TDG to a 2+ (Weak) rating from 2- (Weak).

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

Summary

TDG beat forecasts for fiscal 2Q21 (calendar 1Q) by 4-cents. The quarter included adding back $6 million of inventory cost – which helped EPS by 8-cents. This inventory adjustment results from acquisitions where TDG marks up the value of inventory, which effectively cuts gross margin. It then takes out the fair market value increase from adjusted EPS. There was also $9 million in loss-contract amortization added back – that helped EPS by 12-cents. This occurs when TDG makes an acquisition and determines existing contracts are below-market rates. It books a loss for the contract based on what TDG determines the current market price should be and sets up a reserve for the difference. GAAP records both the higher assumed market price and amortizes the loss into income. Adjusted EPS adds back the loss amortization.

It was another quarter where TDG added back $18 million in COVID costs while also stating that only $1 million was for actual extra COVID cleaning that will not recur. The extra $17 million was worth 24-cents in EPS. We think investors should also be aware of the following:

- TDG uses Average-Cost and FIFO Inventory methods for determining Cost of Goods Sold. TDG's operating model is built for rising raw material costs to help drive margins and earnings. Inventory turns less than 2x per year. However, TDG raises prices quickly to customers:

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Inventory Turn	1.94	1.77	1.99	0.58	1.90	2.05	2.14	2.54

On the call, TDG again pointed out that it doesn't make deals for volume discounts and other areas that would reduce prices for customers. It also noted that it has contracts that let it pass through rising materials costs. According to TDG's president,

"We are very disciplined in adding back costs. We will do so in a very disciplined manner. We will pass along, of course, increased costs in terms of inflationary pressures."

It is also insulated because 60% of gross inventory is raw materials and parts that would need to be cast/manufactured/assembled to be sold. Work in process is another 25% of gross inventory. Thus, it may well have taken price increases that will enable it to replace inventory, but the bulk of it turns so slow it will be selling lower-cost supplies at higher prices.

Also, keep in mind that labor is part of the inventory cost and TDG has been slow in bringing employees back as sales are still weak. It is possible that it could continue to try to bring back workers at a slower rate than sales and that could also help the gross margin going forward for a couple of quarters:

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Gross Margin	49.6%	48.7%	45.7%	48.0%	56.7%	54.7%	57.2%	46.9%
Gross Profit	$592	$541	$536	$491	$818	$801	$882	$713

Margins are showing this already, but sales remain pressured. Even on current sales levels, 100bp of gross margin is worth 16-cents in quarterly EPS. So the using FIFO accounting could help TDG's earnings with inflationary pressures.

- Inventory reserves have also been boosted considerably in recent quarters. They may have topped out in 2Q21. If this declines going forward, it could also help gross margin:

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Inv. Reserves	$190	$189	$178	$162	$151	$134	$124	$117

Total net inventory is only $1.24 billion so the reserve is 13% vs. about 9% pre-COVID. TDG may be in a position to not add much to reserve in the next few quarters and that could help EPS too. Every $10 million decline here is worth about 14-cents in quarterly EPS.

- The debt load remains a big issue for TDG as the tax shield is going down under section 163(j). The tax law changed- previously the amount of interest they could shield against taxes was 30% of EBITDA and now that is 30% of EBIT. Under the CARES act during COVID, companies were given a two-year reprieve where they could shield 50%.

Just looking at last quarter, TDG had interest expense of $268 million. Under the old law, it could shield 30% of EBITDA which was $464 million or $139 million. Under the new law, it can shield 30% of EBIT, which was $394 million or $118 million. The result is going to be a higher tax rate and a higher cash tax payment going forward. This already is happening at TDG as the effective tax rate jumped to 19.6% from 4.2% y/y largely as a result of section 163(j). This will be a headwind for EPS going forward – we estimate about 20-30-cents in EPS per quarter this year.

We think this effectively reduces ROI and the amount of debt TDG can carry. Also, the longer sales and income stay impaired, the worse this is. TDG has debt of 8.3x trailing 12 months adjusted EBITDA. Pre-COVID, it's carrying 6.7x.

- We also want to point out that TDG thinks the audit into defense contract pricing is going smoothly and appears similar in scope to prior audits. The CFO made these comments on the earnings call:

  "*Lastly, and shifting gears from financial matters, I'd like to provide a quick update on our ongoing U.S. DoD IG audit. We've been actively engaged with the IG office with some ebbs and flows and continue to work through the audit process. And our best assessment and based upon what we see, this ongoing audit appears to be similar in scope to our prior audits. While it's difficult to know exactly when a final report could be issued publicly, we expect that this might happen sometime during Q3 or Q4 of our fiscal '21.*"

Air Lease Corp. (AL)
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 maintaining our earnings quality coverage of AL at 4+ (Acceptable).

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

Summary

After 4Q20 results, AL guided investors to expect more lease deferral requests in early 2021. The company did not guide investors to expect the level to jump enough for it to classify $48.7 million of rent due as uncertain from $21.2 million in 4Q. This cost adjusted EPS 43 cents in 1Q21 vs. 19 cents in 4Q20, and AL missed by 1-cent.

We did not lower the rating as AL still has considerable liquidity and continues to see earlier lease deferrals getting paid with total deferrals outstanding actually declining from $144 million to $131 million from 4Q. Plus, the accounting for the lease deferrals is still conservative in that AL waits until the cash is received – so this is more of a timing issue than a lack of payment.

What is strong?

- Liquidity is still over $7.5 billion and S&P moved the outlook up to stable for AL's investment grade rating. The company did lower debt by $351 million in the quarter with refinancing and the issuance of more preferred stock. The quarter saw AL fund its new aircraft purchases from cash on hand.

- Having significant excess cash/liquidity has been a COVID precaution. It is a drag on earnings because it adds interest expense without adding lease revenue. Starting to put some of that excess back to work is a positive sign in our view. Also, the new planes being acquired and leased are happening at pre-COVID contracted rates.

What is weak?

- The company saw its collection rate tick down slightly in 1Q also to 84% from 88% in 4Q. Some of that is tied to the new deferrals and restructurings in 1Q. The company's CEO noted on the earnings call that the pace of new requests for deferrals and restructuring has slowed meaningfully.

- Continued delays in manufacturing at Boeing and Airbus should continue to slow the speed at which AL fully recovers. The business model involves selling planes as they reach 7-8 years old and replacing them. AL sold only 8 planes in 2020 and that is likely to accelerate. Yet, it only took in 26 new planes in 2020 of an originally scheduled 83 for delivery in 2020. Chip shortages could also hamper some of the new aircraft production.

- AL is set up to complete a much larger number of transactions. The trading market for used aircraft may have bottomed at this point and could help going forward with some trading profits and also recycling capital by selling its own planes. Also, AL has talked about getting more sale-leaseback deals done with planes its customers currently own. Keeping so much excess liquidity during COVID was understandable. With that risk decreasing, the delays from Boeing and Airbus – which began long before COVID – may force AL to shrink its liquidity and balance sheet. That may mute the speed of the recovery for AL too.

What to Watch?

- We think the accounting and business model at AL is actually fairly conservative. Delaying revenue recognition until cash is received should give it some higher revenue and cash flow going forward. However, investors should be more focused at this time on how AL is going to grow earnings again. The company either needs to start adding new planes at a faster rate than recent years as its own fleet ages and that capital is recycled, or it will need to retire more debt and repurchase more stock to become a company that is the right size to initiate $2.5-$3.0 billion in new deals per year instead of $5-$6 billion.

- Our last update discusses some of this in more detail – such as leasing becoming a larger part of the overall market to help AL grow. Essentially, AL's cost of funds is far lower than many airlines, so the airlines may benefit from leasing more and owning fewer planes, or earnings can grow via retiring debt and cutting interest expense and/or repurchasing shares.

Sysco Corporation (SYY)
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 SYY at 3- (Minor Concern).

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

Summary

SYY's adjusted 3/21 quarter EPS of 22 cps was 2 cps ahead of the consensus. However, we identified over 7 cps in unusual benefits to the quarter without which the company would have reported a miss.

- Reported other income jumped to $12.7 million of income in the 3/21 quarter compared to $5.2 million of expense in the year-ago period. However, the 3/21 quarter figure included a $10.8 million loss from the sale of a business which is removed from the company's non-GAAP adjustments. This widens the beneficial swing in the non-GAAP other income line items to $29 million, or about 4 cps. We saw no discussion of the source of the swing in the 10-Q or in the conference call.

- SYY shored up its bad debt reserves at the beginning of the pandemic to account for its hard-hit full-service dining restaurant customers. Collections have improved and the company has been writing back some of these reserves as amounts are collected. SYY has adjusted some of these unusual amounts out of its non-GAAP figures by removing both the impact of increased provision expense in the 3/20 and 6/20 quarters as well as removing the benefit of the writebacks in the 9/20, 12/20, and 3/21 quarters. In the 3/21 quarter, the company recognized $33.5 million of benefit from writing back reductions of reserves on pre-pandemic receivables which it adjusted out of its non-GAAP results. However, according to the 10-Q, SYY also reduced its reserves related to receivables generated after the onset of the pandemic by another $10 million. This amount was not removed from non-GAAP results and added over 1.5 cps to earnings in the period.

- The non-GAAP tax rate was 14.3% compared to 19.5% in the year-ago quarter which the company attributed to the impact of stock option exercises. The company has forecast a 24% tax rate for 2021 so we believe it is reasonable to view the entire 1.5 cps benefit in the tax rate swing as unexpected.

- SYY has been adding back restructuring and transformational costs to non-GAAP results ranging from $30 million to over $100 million on a pretax basis for many years. On pre-COVID earnings, these regularly amounted to 10% of adjusted pretax results. In our opinion, the regularity and material size of these charges significantly erode the quality of reported earnings.

Henry Schein, Inc. (HSIC)
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 HSIC at 3- (Minor Concern).

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

Summary

HSIC beat consensus estimates by 40 cps while topping revenue targets by over $100 million. We remain concerned regarding the degree to which the company's growth is still reliant on PPE and COVID-related products. We remain watchful of the restructuring program, looking for any increase in charges or extension of the program. Also, we note there were both positive and negative one-time items in the quarter.

- HSIC continues to benefit from growth in personal protection equipment (PPE) products such as masks and gloves as well as the sale of COVID test kits. The company disclosed that PPE and COVID-related sales amounted to $458 million in the 3/21 quarter compared to approximately $158 million in the year-ago first quarter. The growth in these products amounted to an amazing 60% of the company's total sales growth in the period. Management commented that test kits sales amounted to $180 million in the quarter and we assume that figure was negligible in the 3/20 period. If we subtract the $180 million in test kit sales from the total $458 million PPE and COVID-related figure, that implies PPE-only sales of $277 million. That was $119 million above last year's COVID-related sales of $158 million which accounted for 24% of total company growth. Test kit sales already declined from $270 million in the 12/20 quarter and price deflation is expected to further depress that figure. Management warned in the conference call that it is now seeing growth for PPE products beginning to moderate.

- We note that despite the strong growth in PPE and COVID-related products, health care distribution margins declined *"due to adjustments recorded for PPE inventory and COVID-*

19 related products, as well as influenza diagnostic kits, caused by volatility of pricing and demand experienced during the quarter." We assume the reference to lower demand factor refers to flu test kits which were in low demand due to an almost total lack of flu cases this winter. Meanwhile, the company noted that its cash flow in the quarter suffered due to the buildup of working capital, *"specifically an increase in inventories due to stocking of PPE and other COVID-19 related products."* We believe the inventory writedowns despite strong sales growth for these products reflects how much prices deteriorated since the purchase of inventory that was sold this quarter. The continuing trend of declining demand and deflation may foretell more inventory charges to come.

- The company recorded a gain from the reversal of previous receivables reserves of $2.7 million compared to last year's first quarter where HSIC incurred an unusually high $14.5 million in expense to build up its bad debt reserves at the beginning of the pandemic. This beneficial swing added almost 10 cps to earnings growth in the period.

- More than reversing the benefit of the positive bad debt provision expense was the negative swing in stock compensation expense. In the 3/20 quarter, the company incurred a $17.5 million stock compensation credit when it reduced its estimate of how many shares would be exercised during the pandemic to zero. In the 3/21 quarter, stock compensation reversed to a $12.8 million expense. The negative swing shaved over 16 cps off earnings growth.

- The company's adjusted effective tax rate rose to 25.1% versus 22.5% last year which cost about 3.4 cps in earnings growth.

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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