BEHIND
THE NUMBERS
Quality of Earnings Analysis

May 21, 2021

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

## In this issue:

AT&T Inc. (T) EQ Update- Spinoff Analysis p. 1
National Instruments Corporation (NATI) EQ Update- 3/21 Qtr. p.10
Mowi ASA (MHGVY) EQ Update- 3/21 Qtr. p.13
Ball Corporation (BLL) EQ Update- 3/21 Qtr. p.17

# AT&T Inc. (T)
# Spinoff Update

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

*We are maintaining our earnings quality rating of T at 4+ (Acceptable).*

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

## Summary

We could not be more pleased with AT&T unlocking the undervalued parts of its business this week. We started following the company after the Time Warner deal and we were like many analysts who did not like the purchase (They bought an asset at 12x EBITDA and rolled it into an entity trading for 6x). However, that already drove the stock price down from $43 to about $30 before we were involved and we saw potential in the sum of the parts.

- We thought Warner was always worth at least $10 per share net of $43 billion in debt (10x EBITDA)

- We valued DirecTV at $0 and AT&T sold a 30% stake for $7.8 billion or $1.09 per share plus it should still get some cash flow from the 70% it still holds.

- Subtract the remaining debt from a growing wireless valuation of 7-8x for another $16-$20 per share.

- A debt-free broadband unit is adding $4 billion in EBITDA and growing – is that worth 8x – there's more than $4 more in share value

- The business wireline is generating $9 billion in EBITDA – maybe that's only worth a multiple of 4x-5x – or $5-$6 per share.

- If Vrio, the Latin American phone system, and Xandr are worth anything, the value here was north of $40.

While people reacted negatively to the spin-off because of an announced dividend cut, we think this misses some key points. Primarily, there is an important value driver from Warner still with AT&T – the HBO Max bundle for the mobility unit that should boost AT&T's profits post spin-off. Retiring so much debt is going to help EPS grow and enable AT&T to invest more heavily in its primary businesses – domestic wireless and broadband – rather than fund the international expansion of HBO. We also think the value being given to shareholders from the spun-off unit is worth much more than the level of dividend reduction.

- The forecasts for the combined media spin-off do not look aggressive to us. A forecast of $12 billion in starting EBITDA looks tame considering the two companies did almost $16 billion in EBITDA pre-COVID.

- We think the spin-off in mid-2022 is more likely to trade on 2023's forecasted EBITDA of $14 billion, not $12 billion and the HBO Max will be a larger unit by then too. Many of the lost areas of COVID such as movie releases and some sports should be recovered too. The current trailing 4-quarters have large shut-down impacts and the initial roll-out costs of HBO Max before revenue started coming in.

- When we view the 71% stake AT&T shareholders will get, we see the valuation being worth about $60 billion plus $43 billion of assumed debt. That alone looks favorable compared to the $109 billion AT&T spent on Time Warner and does not assign value to the HBO Max bundling arrangement that remains with AT&T's wireless unit.

- HBO Max has helped AT&T cut churn at its wireless unit by 25-50bp. Every basis point is about $100 million per year in revenue. It has also helped AT&T boost subscribers and get more signed up for premium service plans. Despite paying fees to HBO Max, wireless is seeing EBITDA and margins rise. This deal will remain in place after the spin-off. We value this deal at about $2 per AT&T share.

- The dividend is getting cut – from $2.08 to about $1.20 per share. However, investors appear to be receiving value much larger than the 88-cents in lower annual income in our view. The new shares appear to be worth $7 to us, which should be helped simply trading these assets at a multiple higher than AT&T's stock. That is several years of 88-cents in annual dividends being received upfront.

- The spin-off will also give AT&T shareholders a bump from the media company taking debt of nearly 5x EBITDA – a higher ratio than AT&T's current debt. Keeping the multiple the same but moving debt from 3.1x EBITDA at AT&T to 2.7x as a result of the spin-off, transfers $2.60 per share to the stock value also. Both companies will see growth simply from deleveraging too.

- Much of the dividend cut is coming from AT&T bumping up its capital spending plans to accelerate growth at wireless and broadband. The dividend cut is $6.4 billion. Capital spending would rise from $17 billion in 2021 and $20 billion in 2019. The IRR on this spending is expected to be mid-teens and will double the size of broadband in under 5-years and expand wireless to 200 million POPs by the end of 2023. That should help growth for earnings and EBITDA.

- This will also enable AT&T to abstain from vendor financing which analysts have looked unfavorably toward as it essentially understates capital spending by moving some of it to the financing section of cash flow. Adjusting for this, gross capital spending will rise but actual free cash flow should not drop as much as many think.

- We think this deal sets up AT&T well to deal in a world where interest rates are no longer declining. Before this deal, AT&T had a flat dividend which has a definite bond-like quality when people value in a world when rates are not declining.

- A huge paydown in debt this year, with the spin-off, and to finish 2022 could set AT&T to eliminate 40% of its debt in under 2-years and also means falling interest expense could add $3 billion to earnings growth. The spin-off also will produce growth via deleveraging.

- The higher investment in wireless and broadband should spur growth and the rollout of HBO Max with more content internationally should help the spin-off growth more and solidify its value to the wireless bundle. Growing earnings and

cash flow with lower debt levels already has AT&T talking about growing the dividend post-spinoff, repurchasing shares, or taking debt levels even lower. Faster growth of earnings or dividends could be rewarded by the market especially with two different pure-play investment vehicles.

# Supporting Details

## The Forecasts of the Media Combination Does Not Look Aggressive

Before COVID, Discovery had EBITDA of $4.7 billion and WarnerMedia did $11 billion. The trailing four quarters includes COVID issues, lack of theater distribution, the loss of some sports and paying to roll out HBO Max. During that time Discovery had $3.9 billion in EBITDA and Warner Media $8.8 billion.

The forecast is for the combination to produce revenue synergies that they do not quantify and cost synergies of $3 billion to have a 2023 combined EBITDA of $14 billion. We think the $3 billion in cost savings sounds high. However, getting to $14 billion from an impaired $13 billion does not sound difficult considering pre-COVID the two companies were already ahead of that target. Even paying for more HBO Max rollout may not deflate the $14 billion figure.

AT&T paid 12.5x EBITDA for Time Warner: $109 billion in the form of $85 million split evenly of cash (which it borrowed) and new AT&T shares plus the assumption of about $24 billion of debt. One of the criticisms of the spin-off is AT&T is selling at a loss. AT&T will receive cash and transferred debt of $43 billion and 71% of the new company. The new company with Discovery's $15 billion in debt is expected to close with Debt/EBITDA of 5x which puts the expected EBITDA in mid-2022 at only $12 billion. That makes the selling price for Time Warner $78.5 billion at 9x EBITDA to $104.1 billion at 12x EBITDA.

The first item we would look at is the new company is expected to do $14 billion in annualized EBITDA by the end of the first six months. The extra $2 billion in EBITDA would already add $12.8-$17.0 billion to the value AT&T is receiving at a multiple of 9-12x. We will discuss below that we think keeping the HBO Max deal for AT&T wireless customers is also adding value. We put that at $12-$16 billion. Thus, we don't think AT&T is losing its shorts on this deal:

| NewCo value | 9x | 10x | 11x | 12x |
|---|---|---|---|---|
| 2023 EBITDA | $14.0 | $14.0 | $14.0 | $14.0 |
| Value of company | $126.0 | $140.0 | $154.0 | $168.0 |
| less initial debt | $58.0 | $58.0 | $58.0 | $58.0 |
| Equity Value | $68.0 | $82.0 | $96.0 | $110.0 |
| 71% to AT&T | $48.3 | $58.2 | $68.2 | $78.1 |
| Plus transferred Debt | $43.0 | $43.0 | $43.0 | $43.0 |
| HBO Max Deal | $12.0 | $12.0 | $12.0 | $12.0 |
| Value to AT&T | $103.3 | $113.2 | $123.2 | $133.1 |

## AT&T Will Have the Benefits of a Larger HBO Max for Its Wireless Bundle

In the year since the launch of HBO Max, the number of subscribers for HBO has increased from 33.1 million to 44.2 million. HBO Max has been one area where AT&T has seen some synergistic value from the deal as it offers it to wireless customers. This has spurred growth in numbers of clients and growth for premium service plans at mobility, which is driving revenue in that unit. It has also helped reduce churn among its customer base:

- Postpaid churn is down to 0.76% from consistently being 1.00-1.30% in prior years. AT&T has pointed out that 1bp of churn is worth about $100 million in revenue at wireless and the margin is likely higher margin as it avoids the costs of set-up and activation when a customer stays. The company has pulled 25-50bp of churn out of the unit.

- The service margin at mobility is rising too and is now 57% on a rate of $14 billion per quarter revenue figure. That is still being negatively impacted by the loss of roaming fees and late payment fees. In 2020, AT&T spent about $2 billion on the HBO Max roll-out, which fell largely on WarnerMedia and Mobility. Despite the expense and the lost roaming fees, margins are up, EBITDA is up, and revenues are up.

- Adding Discovery's content to the mix should not hurt the appeal of the HBO Max bundle on the mobility unit.

AT&T's mobility unit will continue to have a tie-up with HBO Max it can offer customers. That looks like some future value from WarnerMedia that will remain with AT&T after the spin-off:

> Per John Stankey at AT&T ***– "[HBO Max] has been a highly beneficial relationship despite some of the commentary that I picked up we get a lot of benefit from churn in our core connectivity business. You know what our customer acquisition volumes have been. So we have every motivation and incentive to keep a differential relationship with the company moving forward.*** *I believe we're going to see new points of aggregation for content as we move forward. I think wireless is starting*

*to demonstrate itself. A wireless subscription is one of those points of aggregation, and it's going to be important that we think about servicing our customers as a result of that.*

*But when you think about what happens here,* ***the opportunity for David to grow this media company globally is what outstrips the value creation from us owning the asset and driving churn and customer acquisition and connectivity domestically in the U.S.*** *and allowing him to go after an opportunity globally that's got a much bigger multiple on it.* **But our intent is to continue relationship.** *And then the share owners that stick with the new entity, will, of course, get the benefit of that as it continues to grow in scale through that distribution partnership, and we just think that's a better way for us to handle the capital structure right now given the growth requirements on the new media business."*

Per David Zaslov at Discovery – "***we've seen what John's communications business has done for HBO Max. It's hugely valuable for both. It's a great relationship****. And AT&T is only going to get stronger and more power. It's already the top direct-to-consumer company in America. With an extraordinary brand. So we hope we -- for years to come, we'll be figuring out how to create value for each other."*

When we look at this relationship that will remain with AT&T, it doesn't require capital spending by AT&T yet still helps AT&T add business and do so at higher rates. What is 30bp of churn worth at a 50% margin? That's $1.5 billion per year. What is higher ARPU worth from having customers take premium plans? 53-cents of ARPU is another $0.5 billion per year. In total that would be $2 billion in incremental EBITDA to AT&T from the HBO Max deal. Value that at 6-8x for $12-$16 billion in value still at AT&T after the spin-off. That's worth $1.70-$2.25 per share in our view.

## But AT&T's Dividend Will Be Lower…

The howls of the spin-off focus on AT&T announcing it will cut its dividend when the spin-off is complete. The current dividend is $2.08 per share or $15.0 billion in total. The new one is expected to be 40%-43% of free cash flow of $20 billion or about $8.6 billion and translates to $1.20 per share. An 88-cent annual cut.

The first thing we would point out is shareholders are getting some substantial value from this deal. Unlocking the sum-of-the-parts valuation involves changing the form of cash flows. The $2.08 dividend will be paid for another year. Then in exchange for losing 88-cents in annual dividend – shareholders will receive:

- 71% of the new company. The market is saying this equity is worth $5 per AT&T share based on $12 billion in EBITDA at 9x. We'd say it's worth at least $7 using the $14 billion EBITDA forecast at the time and the same 9x multiple. It could be worth as much as $10

per AT&T share with a slightly higher multiple. No matter how this is viewed – NewCo's media assets should trade higher than AT&T's EBITDA multiple of 6-7x. That alone is unlocking value.

- The new company is expected to grow at a faster rate than AT&T, which should support a higher multiple and anticipates that debt will rapidly fall from 5x $12 billion in EBITDA to 3x within 24-months. That would mean EBITDA at NewCo would rise to $19 billion if no debt was actually paid down, or $16 billion if debt was reduced by $10 billion over those two years. Either way, that is sizeable growth and should translate into a higher stock price for NewCo over time.

- A distribution of $5-$7 of NewCo is already worth more than several years of 88-cents of annual dividends. If NewCo grows, the appreciation looks like it should also exceed 88-cents in annual dividends.

- Shareholders also retain stock in AT&T that now loses $8.8 billion in Warner EBITDA, but also loses $43 billion in debt. That's a higher Debt/EBITDA multiple than AT&T as a whole. Just removing the $43 million in debt drops AT&T's debt ratio from 3.1x to 2.7x. Keeping the same multiple on AT&T and using the lower EBITDA – the reduced debt ratio moves $18.5 billion from debt to the stock or $2.60 per share. That's over 3-years of the 88-cents too.

- Plus, AT&T still has the HBO Max bundling deal after the spin-off. That is pushing down churn and boosting ARPU for the wireless unit. Higher EBITDA there looks like that is worth about $2.00 per share also.

## Some of the Dividend Cut Is Due to Ramping Up Investment in AT&T

Lower debt levels and not having to devote efforts to media with this deal also has AT&T talking about investing in more growth for its wireless and broadband units. Stockholders have wanted this for years as they derided the DirecTV and Time Warner deals and the debt situation.

According to AT&T, it will seek to double its broadband business from 14 million customer locations to 30 million by the end of 2025. It also plans to deploy the new spectrum it just bought to expand POPs to 200 million by the end of 2023. That should enhance speed, quality, and desirability of the network.

That doesn't happen for free, AT&T expects to boost capital spending to $24 billion from the current level of $17 billion. Thus, when looking at where the dividend cut of $6.4 billion is coming from ($15.0b now to $8.6b expected) – stop attributing it all to spinning off Warner. It's being reinvested in growth. AT&T is touting that investment in these two areas is generating mid-teens for rates of return. That exceeds the dividend yield.

In reality, the bump in spending is closer to $4 billion as AT&T will also clean up the Vender Financing situation that has been on the cash flow statement. In past years, some of the heavy capital spending in current years was being financed by its suppliers. That resulted in lower cash outflow for capital spending, but it also moved payments to vendors out of the investing section of cash flow and into the financing section. Thus, the lower net spending was not including the payments for prior capital spending that were in reality lowering free cash flow. Computer analysis doesn't pick up the true free cash flow figures. Here's what was happening:

| | post-spin | 2021e | 2020 | 2019 |
|---|---|---|---|---|
| Cash from Ops | $44.0 | $43.0 | $43.1 | $48.7 |
| Cap-Ex | $24.0 | $17.0 | $15.7 | $19.6 |
| Free Cash Flow | $20.0 | $26.0 | $27.4 | $29.1 |
| | | | | |
| Cap-Ex | $24.0 | $17.0 | $15.7 | $19.6 |
| Vendor Payments | $0.0 | $4.0 | $3.0 | $3.1 |
| First Net Reimb. | $0.0 | $1.0 | $1.1 | $1.0 |
| Gross Cap-Ex | $24.0 | $22.0 | $19.7 | $23.7 |

According to the CFO Pascal Desroches – on the change:

> *"Vendor financing right now, we have vendor financing where we're spending on CapEx that doesn't go through free cash flows. And we have CapEx spent for cash. Going forward, our intention is virtually all of the CapEx will be cash CapEx unless we find really, really attractive terms to vendor financing. So the $24 billion is an all in number, and that's how you should take it."*

> *"Going forward, we intend to phase out most of our vendor financing arrangements. Strengthening our balance sheet will give us greater flexibility going forward. This could give us the option to increase our dividend and/or repurchase shares in the future."*

## AT&T Is Set Up Well for the Future

Against the backdrop of some pressure from inflation and higher movement in interest rates, we think AT&T was in good shape already before the spin-off. What attracted many to the stock was the high dividend. However, it wasn't growing the dividend and that was unlikely to change anytime soon. With no inflation and low interest rates – no one cares. With those pressures building, it would likely have reacted as if the stock was really a junior-class bond – fixed coupon and super long maturity.

The way to beat inflation and higher interest rates is with some growth and reducing leverage. There are many areas where this should happen with AT&T and the spinoff:

- AT&T has $169 billion in debt at an average cost of 4.4%. It was already targeting $15 billion in debt reduction this year keyed by the sale of 70% of DirecTV and Crunchyroll. The spin-off will remove $43 billion more in debt in a year. It also sets the company up to have free cash flow after the dividend of $11+ billion per year to retire more debt. AT&T could end 2022 with only $100 billion in debt. That would save $3.0 billion in interest expense and would add 33-cents to EPS. Cleaning up vendor financing also deleverages AT&T.

- More deleveraging could happen with the pension plan. At the end of 2020, the pension plan was underfunded by $7.6 billion. PBO was $62.2 billion. However, from 2018 to 2019, the discount rate to estimate the PBO fell 110bp from 4.5% to 3.4% and added $8.0 billion to PBO. From 2019 to 2020, the discount rate fell another 70bp to 2.7% and added $5.6 billion to PBO. It would not take much in the way of higher interest rates to reverse this trend and cure the underfunding level.

- AT&T would be in a position to retire more debt or repurchase shares. If they acquire $9.0 billion in stock (at $30), it would add 4% to EPS growth and they could add a nickel/share dividend for 4% dividend growth, while keeping the total dividend outlay flat at $8.6 billion. If they retire $9.0 billion in debt at 4.4%, it would add 4% to EPS growth too. As the CFO noted on the call, *"Strengthening our balance sheet will give us greater flexibility going forward. This could give us the option to increase our dividend and/or repurchase shares in the future."*

- Broadband is expected to double in size in under 5-years at a double-digit ROI – that should be producing growth as should the additional spending at mobility.

- We know HBO Max is producing higher revenue and EBITDA at mobility and HBO Max will add more content. Mobility is also expected to see roaming fees return that have been costing the company earnings already. It should be able to charge more for 5G going forward and it continues to add FirstNet subscribers as well their families. That sounds like growth too.

- The stand-alone media company can tackle international expansion without AT&T paying for it and allowing AT&T cash flow to invest in mobility and broadband. Yet, the media company will likely still have a higher valuation multiple than if it was part of AT&T and should have good growth itself from expansion and deleveraging too.

# National Instruments Corporation (NATI)
# 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 rating of NATI at 5- (Strong).*

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

## Summary

NATI beat non-GAAP EPS forecasts by 1-cent coming in at 32-cents. It did pick up $4 million y/y from lower travel costs due to COVID – which added 3-cents to EPS. It also faced a drag from variable compensation increasing $8 million in 1Q21 vs. $3 million in 1Q20. Moreover, all of 2020, the expense was only $8 million. So, NATI was hit for 3-cents there in EPS for the quarter.

One of the bigger drags was simply fewer sales were reported due to a shortage of parts in the supply channel with several end-markets growing at double-digit rates. Normally, backlog is only about one week's sales and after 1Q21, it was more than 2 weeks. One week's sales is $26 million. If we assume that NATI is NOT planning its R&D, G&A, and some other overhead costs on a week-to-week basis, then much of that incremental $26 million would have become earnings – likely at least 50% if not 60%. That is where NATI was probably light by about 7-9 cents in EPS for 1Q21 given how strong demand was that it couldn't post as sales.

We saw some positives here for the company's earnings goals. First, it wants to boost software sales to more than 30% of total revenues, which should be higher margin. Second, NATI has one of the easiest restructuring plans in process which is focusing on making smaller accounts less labor-intensive and reducing the workforce – which began in 4Q20. Already, NATI reported 60bp of gross margin gain from sales mix (which we believe is primarily more software sales). That helped EPS by just over 1-cent. The workforce reduction already helped costs by $7 million, which was over 4-cents. Those two trends should keep working to boost EPS going forward.

There should be a tough 2Q, but it could set up a sizeable rebound in earnings after that with margin leverage and higher sales. We think NATI will end up realizing strong EPS growth after getting through the current shortage of key inventory parts.

## What is strong?

- NATI has addressed several times that its backlog is growing and should continue to grow in 2Q and into part of 3Q. However, its backlog still turns into revenue and is not customers double or triple ordering per management. Also, the sales force continues to sign up more business encouraging customers to get in the queue. It will be delayed. This should create better visibility for sales forecasts as NATI turns the corner on parts. As we discussed above, there should be considerable operating leverage implications for NATI with this where margins may face some pressure in 2Q and start to see larger increases in sales and margins in 3Q and 4Q.

- NATI's restructuring plan appears largely complete. The company is adding back these charges to adjusted EPS and recorded $30 million in 4Q20, $6.3 million in 1Q21, and only expects $3 million more. The plan was expected to be completed in 9-12 months and our estimate was it could add as much as 10-cents to quarterly EPS. This should offset some of the delayed sales in 2Q as well.

- We are not seeing much in working capital to get alarmed about and the company continues to spend on R&D. Only inventory levels are down, which is to be expected in the current supply shortage situation. Rebuilding some of that may also help gross margin in 3Q and 4Q. It is also worth noting that NATI did discuss that it is working to re-engineer some products with fewer parts or available substitutes. This may help resolve this supply issue more quickly and may result in better margins too. Arguably, sales being light, likely made the DSI figure look better at 196. An extra $15-$25 million in sales would have had the DSI at 165-175 days- much closer to what 4Q ended at:

| | 1Q21 | 4Q20 | 3Q20 | 2Q20 | 1Q20 | 4Q19 |
|---|---|---|---|---|---|---|
| Inventory | $197 | $194 | $210 | $210 | $208 | $200 |
| DSI | 196.3 | 167.6 | 216.4 | 228.6 | 231.8 | 204.8 |
| | | | | | | |
| Receivables | $241 | $267 | $215 | $212 | $213 | $249 |
| DSO | 65.6 | 66.2 | 63.6 | 64.9 | 62.8 | 61.8 |
| | | | | | | |
| R&D Spending | $80 | $74 | $71 | $64 | $72 | $72 |
| % Sales | 23.9% | 20.0% | 23.0% | 21.3% | 23.1% | 19.4% |

## What is weak?

- NATI missed the size of this supply chain shortage after saying on the 4Q call that it could navigate supply constraints and again – that is why they carry above-average inventories. The size of the rebound in demand coupled with the supply issues led NATI to miss on revenue forecasts for 1Q and indicated that 2Q will also be constrained and 3Q may see a turnaround begin. That will make for a lumpy 2021.

- NATI took a $3.5 million impairment of an equity investment. It didn't give much detail about this. It was added back to adjusted EPS as well.

## What to Watch?

- We still expect the spread between NATI's GAAP and Non-GAAP EPS to narrow going forward. Primarily, the integration and restructuring charges should shrink considerably going forward. NATI is simply not capitalizing as much software costs as we have discussed before and that amortization account will shrink. COVID was about 1.5-cents in expense for 1Q21 and NATI guided for that to continue through 2021, but at some point, that should vanish. That will leave stock compensation and amortization of acquired intangibles which NATI at lease expenses very quickly:

| | 1Q21 | 4Q20 | 3Q20 | 2Q20 | 1Q20 | 4Q19 |
|---|---|---|---|---|---|---|
| GAAP EPS | $0.03 | $0.04 | -$0.04 | $0.08 | $1.01 | $0.45 |
| Stock Comp. | $0.13 | $0.12 | $0.12 | $0.09 | $0.08 | $0.10 |
| Amtz Acq Intang. | $0.06 | $0.07 | $0.06 | $0.01 | $0.01 | $0.01 |
| Intgration/Restruct. | $0.11 | $0.27 | $0.10 | $0.04 | -$0.87 | $0.08 |
| Amtz Software | $0.05 | $0.04 | $0.05 | $0.04 | $0.03 | $0.04 |
| Tax Impact | -$0.06 | -$0.03 | -$0.06 | $0.00 | $0.00 | -$0.12 |
| Non GAAP EPS | $0.32 | $0.51 | $0.23 | $0.26 | $0.26 | $0.56 |

# Mowi ASA (MHGVY)
# 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 rating of MHGVY at 4+ (Acceptable).*

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

## Summary

1Q21 results at MOWI showed good improvement sequentially and were flat with 1Q20 results at €109 million when pricing collapsed when COVID hit near the end of the period. The company had its largest harvest of salmon of any first quarter. Pricing has recovered from a very low starting point and that still had a negative impact on overall results. Thus in both first quarters, there was a wide swing in prices that impacted results. However, looking at the recent trends points to continued improvement going forward. Cash flow guidance remains the same on capital spending, working capital build, and interest with only tax guidance rising to €80 million from €20 million. Higher taxes implies some higher income. Also, MOWI reduced debt with the proceeds of its DESS sale and retains ample liquidity.

We think investors should note that the 32-NOK dividend introduced in 4Q20 was boosted to 77-NOK in 1Q21 based on the stronger pricing improving earnings – the goal is to pay a dividend of 50% of earnings. Also, one of the bigger earnings swings is marking biomass to reflect rising/falling valuations. During COVID, MOWI wrote down fish in sea pens by €200 million in 1Q20 and 2Q20. Since then, the valuation has recovered by €148 million with €92 million in 1Q21 based on higher period-end pricing. Also of note, the weight of fish in the pens is down 6% from 1Q20 based on higher harvest volume this period, thus, MOWI has likely recovered nearly all of the COVID markdown.

## What is strong?

- Demand growth of 15.9% y/y exceeded supply growth even though supply grew at 14.4% as MOWI had the largest 1Q harvest ever. We take that as solid evidence that strong pricing seen as 1Q21 moved along could continue.

- Supply growth forecasts for the year remain subdued. The 1Q's 14.4% was higher than expected due to harvesting more large fish and early harvests in Chile. The full-year industry forecast remains low at 1%-4% vs. prior guidance of 0%-4%. This includes forecasts of -4%-0% in 2Q and -2%-1% in 2H21. Much of this is based on Chile seeing production fall by 15% in 2021 and given that harvesting happened earlier in 1Q for Chile, there simply isn't as much salmon ready for market coming from Chile in the rest of the year. MOWI should also benefit from this as its forecast is to see 5% y/y volume growth in 2Q.

- Pricing has already responded. We noted last quarter that under COVID pricing for salmon had been €4-5 per kg vs. the normal €6+ per kg. An extra €1 would almost double MOWI's EBITDA. For 1Q, MOWI posted flat operating income y/y of €109 million. That was due to salmon farming being down €34 million against consumer products being up €30 million. Salmon farming had lower costs and higher volumes but lower pricing for the quarter was about double the impact of the higher volumes. In 1Q20, MOWI had strong pricing for about 10 weeks and then saw it collapse. In 1Q21, MOWI had poor pricing early on, and then pricing strengthened at the end of the period. Salmon started the quarter at just over €4/kg and finished just under €7/kg.

- Consumer Products had another very strong quarter. It didn't quite match 4Q20's record of €34.8 million in EBIT but came in at €32.2 million. Dining restrictions have helped this unit post stronger sales and profits. However, MOWI delayed rolling out its brand name and all consumer products last year with COVID. Much of the consumer products results still come from Europe - €20 million of the €32 million total in 1Q21. On the call, MOWI noted it is launching into new stores in the UK and US, along with Belgium, Italy, Spain, and working on Chile, Brazil, and Columbia.

- Cost-cutting continues as MOWI is still targeting €25 million in lower structural costs for 2021 on top of €35 million realized after 2020. That level of cost savings would add about 10% to pre-COVID earnings and could help the dividend grow in the future. Biologic costs were down as well as operating costs for farming. Despite rising costs for many agricultural commodities and fish – MOWI still reported lower feed costs overall. That may increase in 2Q more and become more of a headwind.

## What to Watch?

- MOWI was betting on pricing increases and reduced the amount of its future sales tied to contracts to only 21% in 1Q and only 25% for the year. This will give it much more spot pricing, which is rising. Normally, MOWI has 2-3x these levels under contract which shaves off the highs and lows of spot price volatility – we would expect future contract sales to rise again as pricing nears higher levels.

- Foodservice in the US may be open, but much of Europe it was still closed during 1Q. The UK opened May 17. Sushi places in Japan have seen higher takeout orders, but there are still restrictions in many Asian countries. Foodservice consumes more salmon than the retail sector. When restaurants closed and retailer demand soared – it was still about a 10% loss of overall salmon demand. As more restaurants reopen for inside dining – it should further add to demand growth and possible drive pricing higher given the forecasts for supply growth to be essentially 0% the rest of 2021.

- China has had restrictions on foodservice and issues with supplying the market due to reduced airfreight capacity being available. There have also been trade issues. China had been a growth market for salmon and reached 4.8% of world demand in 2019. That dropped to only 3.1% in 2020 and even against a weak comp for 1Q, Chinese demand fell to only 2.3% of the world total. Having this market recover should further bolster salmon pricing.

- The NOK/Euro exchange rate can also help MOWI's earnings growth. Normally the exchange rate is just under 10 NOK to the Euro. Under COVID, it spiked to over 12 and remained higher for most of the year. Other salmon farmers function in NOK while MOWI functions in Euros. When the NOK lost strength, the other farmers could cut prices more easily and fish that were being harvested and that contributed to the pricing pressure in 2020. The weaker NOK also meant those farmers were paying more for feed costs during 2020 and have more cost invested in the current salmon. That will pressure the NOK farmers to hold pricing higher. At the same time, MOWI's own feed costs were cheaper with the stronger Euro so its embedded cost is lower. The NOK/Euro exchange is now at 10 to 1 – just a tad above normal at this point so these impacts should be muted in the near future. However, the market may see more pressure for higher pricing as the current fish are harvested and MOWI's cost to raise some of these fish should be lower.

- There may be less room for share appreciation from the USD/NOK ratio. MOWI's shares trade in NOK and its dividend is paid in NOK. For the US shares, that converts to dollars. Since the drop of $100 oil, the exchange rate has been about 8 NOK to the dollar. Under

COVID, that spiked to over 11 to 1, and having it drop back to the mid-8s has helped MOWI's stock price in the US. Over a much longer timeframe, the exchange rate is closer to 5 to 1. But the COVID driving FX appreciation seen since last May has largely been realized.

- The dividend should rise with earnings with a goal to pay out about 50% of earnings. Historically, MOWI earned about $1.20-$1.40 per share in dollars before COVID, before some new capacity, before consumer products, and before some cost reduction efforts. We think the dividend could grow from the 4 cents in 4Q20 and 9 cents in 1Q21 toward 15-20-cents per quarter based on past results. And if the new products, pricing, and volumes grow – it could grow with those results too.

# Ball Corp. (BLL)
# 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 BLL at 3- (Minor Concern).*

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

## Summary

BLL reported adjusted EPS of $0.72 which beat the consensus estimate by 5 cps. The company continues to spend to build capacity. BLL had 100 billion in unit capacity in 2019 and ended 2020 with 107 billion. It will add another 15 billion units of capacity in 2021 with a total expansion to 125 billion expected to be complete by 2023. Management has indicated that current sales are constrained by capacity and it will be able to sell all the new cans at attractive prices.

The buildout of additional capacity has resulted in elevated capex. Capex was $1.1 billion in 2020 and is expected to be $1.5 billion in 2021. This is almost 3 times the $500-$800 million range from 2018 and 2019. When the new lines are up and running, the company expects cash flow to double by 2025. If all this happens according to plan, the company will be able to pay off the debt generated to pay for expansion which currently sits at 3.3x EBITDA. However, if there are unexpected hiccups, we believe risk is increased by the company's heavy use of factoring receivables and increasing payables to help boost cash flow in the short run.

- Estimated factored receivables declined by over $100 million sequentially and were roughly flat on a days-of-sales basis. As we noted in the last review, the YOY growth in factored receivables appears to be topping which could be a headwind to cash flow growth in the second half of the year. BLL has essentially utilized its factoring program to help boost cash flow in the short run as it spends heavily on building new capacity. The growth in factored balances has essentially been flat in the last three quarters. The YOY boost to rising factored balances will be up in the second half unless the company further

expands its use of the program. This may be difficult to do with the limit already at $1.6 billion.

- Accounts payable days jumped to 121 from 107 a year ago and 109 in the 3/19 quarter. We estimate this could have added more than $400 million to cash flow growth in the quarter. We will be watching to see if the company tries to further extend payables during the remainder of the year to help fill the cash flow gap.

- The buildout in capacity has led to an increase in PPE on the balance sheet. However, depreciation expense has remained flat despite the company opening its new lines in Ft. Worth, Texas and Rome, as well as its new Glendale, Arizona plant in 2020. As more plants are brought online in 2021, depreciation expense cannot help but catch up to the increase in PPE. We estimate that if depreciation expense as a percentage of gross PPE increases to the pre-buildup level, it could cost 8 cps per share in incremental quarterly depreciation expense. We are not sure if any of this is included in the company's $50 million in forecasted startup costs for 2021.

- The effective tax rate fell to 15.2% in the 3/21 quarter which added about a penny per share to EPS. The company is now forecasting an 18% rate for full-year 2021 which should result in relatively even YOY tax rate comparisons for the next couple of quarters.

- The company's contracts have pass-through provisions which should help protect it from rising aluminum prices. Still, management warned on the call that other factors of production will be impacting by inflation.

# Supporting Detail

## Factored Receivables Have Levelled Out

We have been following the ramp-up in factored receivables for the last several quarters. The following table shows trade and unbilled receivable DSOs and estimated outstanding factored receivable DSOs for the last eight quarters. Note that we arrive at our estimate of outstanding factored receivables by taking the difference between the limits of the factoring facilities and the amounts outstanding under the facility at the end of the quarter.

| | 3/31/2021 | 12/31/2020 | 9/30/2020 | 6/30/2020 |
|---|---|---|---|---|
| Sales | $3,125 | $3,102 | $3,093 | $2,801 |
| Net Trade + Unbilled | $1,640 | $1,344 | $1,418 | $1,447 |
| DSO | 47.2 | 39.9 | 42.2 | 47.0 |
| Outstanding Factored Receivables | $1,252 | $1,368 | $1,316 | $1,073 |
| Factored DSO | 36.1 | 40.6 | 39.1 | 34.9 |
| Adjusted Receivables | $2,892 | $2,712 | $2,734 | $2,520 |
| Adjusted DSO | 83.3 | 80.4 | 81.3 | 81.9 |

| | 3/31/2020 | 12/31/2019 | 9/30/2019 | 6/30/2019 |
|---|---|---|---|---|
| Sales | $2,785 | $2,719 | $2,953 | $3,017 |
| Net Trade + Unbilled | $1,417 | $1,186 | $1,405 | $1,511 |
| DSO | 46.3 | 40.1 | 43.8 | 45.6 |
| Outstanding Sold Receivables | $1,098 | $1,170 | $1,145 | $1,092 |
| Factored DSO | 35.9 | 39.6 | 35.7 | 32.9 |
| Adjusted Receivables | $2,515 | $2,356 | $2,550 | $2,603 |
| Adjusted DSO | 82.2 | 79.7 | 79.4 | 78.5 |

On the bright side, YOY growth in DSOs including factored amounts has been steady the last couple of quarters, so the company is not masking a ramp-up in receivables by removing them from the balance sheet.

However, we can see that outstanding factored receivables ranged between $1 billion to $1.5 billion from the 6/19 quarter to the 6/20 quarter before jumping to the $1.3 billion level in the 9/20 quarter. This led to a big YOY jump in factored receivable DSOs in the 9/20 quarter and to a lesser degree in the 12/20 quarter. The increased use of factoring has been a boost to cash flow growth as the receipt of cash is accelerated. However, factored receivables showed a slight sequential decline in the 3/21 quarter and if BLL does not ramp up factoring again, the boost to cash flow growth will begin to wane, especially after it laps the big jump in factoring in the 9/20 quarter. This may be tough to do with the limit of the current facility already at $1.6 billion.

## Payables Jump

The following table shows the days payable outstanding (DPO) calculation for the last twelve quarters:

| | 3/31/2021 | 12/31/2020 | 9/30/2020 | 6/30/2020 |
|---|---|---|---|---|
| Trade Accounts Payable | $3,355 | $3,430 | $2,832 | $2,699 |
| Cost of Products Sold | $2,493 | $2,448 | $2,430 | $2,230 |
| DPO | 121.1 | 128.9 | 107.2 | 110.1 |

| | 3/31/2020 | 12/31/2019 | 9/30/2019 | 6/30/2019 |
|---|---|---|---|---|
| Trade Accounts Payable | $2,613 | $3,136 | $2,658 | $2,739 |
| Cost of Products Sold | $2,215 | $2,159 | $2,363 | $2,428 |
| DPO | 107.4 | 133.6 | 103.5 | 102.7 |

| | 3/31/2019 | 12/31/2018 | 9/30/2018 | 6/30/2018 |
|---|---|---|---|---|
| Trade Accounts Payable | $2,739 | $3,095 | $2,953 | $2,739 |
| Cost of Products Sold | $2,253 | $2,246 | $2,362 | $2,484 |
| DPO | 109.4 | 126.8 | 115.0 | 100.3 |

Accounts payable typically falls $400-$500 million sequentially in the first quarter. However, the balance declined by only $75 million in the 3/21 period. This would have added well over $400 million to cash flow growth in the quarter. DPOs have not been significantly out of line with historical trends in the previous three quarters. We will be watching to see if the company attempts to keep extending payables as a form of short-term financing to cover its cash flow shortfall.

## 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

*Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.*

*The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.*

*This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.*

*Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.*