BEHIND
THE NUMBERS
Quality of Earnings Analysis

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In this issue:

Conagra Brands, Inc. (CAG) EQ Update- 3/21 Qtr. p. 1

Macquarie Infrastructure Corporation (MIC)- Update on AA Sale p. 9

BTN 2Q'21 Focus List p.12

Conagra Brands, Inc. (CAG) Earnings Quality Update

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 CAG to 2- (Weak).

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

Summary

CAG beat 3Q21 estimates by only 1-cent at 59-cents, which by itself is a red flag as it routinely has several short-lived items to help results and the outlook was 56-60 cents. This quarter was no exception. The income tax rate fell 90bp and added 1-cent to earnings. Lower travel-related spending added 0.6-cents, adding back legal and consulting fees was 2-cents. One of the bigger areas is reduced trade promotion, which is netted against sales rather than called out as an expense. In the 2Q, CAG said half its 1.5% pricing gains were from lower trade promotion which

added 3.3-cents. In 3Q, CAG said half of the 3.6% in pricing gains came from less trade promotion, which added 7.1-cents.

We also think COVID-related spending should be getting lower at this point, not rising. In 2Q, CAG said COVID was 100bp drag on margins or $30 million. In 3Q, CAG said the drag was 180bp or $50 million and said that it is including $15 million of higher transportation costs in that figure.

The trucking costs being classified as COVID-related and the outlook for 4Q shows us that CAG is having a tough time navigating cost inflation. This is not a company that has had much success holding volume growth when it wants to take pricing and restocking demand may be largely complete now.

What is strong?

- Volume growth was higher last quarter than we expected at 6.1%. We knew there was some more channel restocking coming and winter storms likely helped too.
- CAG actually boosted SG&A-type advertising in the quarter. It was up $7.8 million as normalized operating activities resume.

What is weak?

- CAG is slashing promotional spending which is reported net of sales. This is inflating reported pricing and total sales by $45 million last quarter, which was a surge from $21 million in 2Q21. It also inflates operating margin via higher sales and higher operating income.
- CAG gained 7.1 cents in EPS from cutting trade promotions and it is still spending less than historical levels on traditional advertising. These activities have added 120bp to margins through the first 3Qs of fiscal 2021. We believe this will reverse going forward.
- Foodservice demand is normally about 10% of sales and fell to 7% with COVID. That should recover as restaurants open and seating capacity is expanded. However, Food Service has a margin of half the level of CAG's other businesses that serve grocery stores. Simply moving 3% of company sales from grocery to foodservice is a 30bp headwind on margins.

- Commodity inflation is starting to overwhelm CAG's pricing. Gross margin rose 130bp through 3Qs of fiscal 2021, but only improved 10bp in 3Q21. CAG is warning investors to expect price increases to lag cost inflation. CAG has a history of losing market share when it tries to raise prices faster than store-brands experiencing the same inflation.

What to Watch?

- The Outlook is calling for organic CAGR of 1%-2% for the three years ending in May 2022 (fiscal 2022). That guidance looks poor to us given that the four COVID quarters each divided by twelve is a 3-year growth rate of 4.4%. It is not a shock that volume growth should turn negative against COVID quarters, but there are several positives with COVID that expanded margins that may not be sustainable under more normalized times beyond the marketing cuts and foodservice margins. Leveraging fixed costs over more volume may reverse. Higher sales also leveraged higher employee pay during COVID – does the high pay remain but the sales decline? Normal product turnover often requires marking down what's on the shelves to clear space for new items – panic buying under COVID cleared the shelves at full price. Discounting wasn't needed.

- CAG's results for the two years prior to COVID were awful as it sought to cut marketing and boost pricing. It resulted in large volume losses for many products and inventory was stacking up. CAG seems to be guiding that it will be able to navigate without marketing at past levels, lose some volume and maintain margins. We see items that may total more than 200bp of margin headwind. CAG can point to reducing COVID costs at about 100bp, but that would require it cuts employee pay too to recapture all of that.

Supporting Details

CAG Is Driving Sales and Earnings Results by Cutting Marketing

CAG reports marketing in two areas. The first is the more traditional SG&A-type advertising spending where details are given. The second is trade promotion, which includes coupons, discounts to retailers, slotting fees paid to retailers, and having people in the store pitching products and giving out free samples. This type of marketing is reported net of sales and is not always quantified.

Both types of marketing are important for a company that wants to boost prices. And investors should not forget that before COVID, CAG's entire business plan was centered on the concept of Value over Volume. It was willing to concede volume to boost price. Retailers tend to want higher volume items on the shelves that customers demand. If CAG's products aren't turning as quickly, they lose shelf space or need to pay more to stay. This is especially true with releasing new products. They have to take shelf space from another product. CAG has touted how it wants to have a high percentage of new products at all times. All of these goals, pricing, value over volume, and new products require marketing. Yet, CAG has been slashing its spending:

We have data on the traditional type of advertising and CAG saw it turn up last quarter, but is still below past levels when it didn't even own Pinnacle Foods:

Conagra Advertising	4Q	3Q	2Q	1Q
fiscal 21		$73.3	$63.6	$45.9
fiscal 20	$59.2	$65.5	$60.7	$45.3
fiscal 19	$73.9	$67.4	$69.4	$42.7
fiscal 18	$59.5	$78.2	$86.0	$54.9
fiscal 17	$75.5	$90.7		

We remember late fiscal 2019 and the early quarters of fiscal 2020 before COVID lockdowns caused retailers and customers to buy anything on the shelves. In the normal world, CAG had to fight for shelf space against many other competitors and compete on pricing and promotional spending to get grocery store real estate. Their results of trying to take some pricing and cutting marketing were awful:

- *Marie Callender's* down 20%
- *Hunt's* Tomatoes down 10%
- *Chef Boyardee* down 7%
- *Wish-Bone* salad dressing down double digits for years
- *Birdseye* seeing accelerating declines

As COVID ends, we think the competitive world will return. Customers will not need months of pantry stocking and CAG earnings were often made or missed by a single winter storm or hurricane threat causing people to stock up for a week. It will also mean stores will require suppliers to spend more money on their products to keep them turning rapidly and that means trade promotion should return in a big way.

During COVID, CAG did not need to invest as much in trade promotion. As that type of spending is netted against sales, when it doesn't happen, sales magically rise. In the last three quarters, CAG has given detailed discussions on how much the price component of sales came from having lower trade promotion and these cuts have been huge and getting larger:

	3Q21	2Q21	1Q21
Sales Growth from lower promotion	180bp	75bp	70bp
y/y higher sales from lower promotion	$45.340	$20.800	$17.800
Net of tax	$34.500	$16.000	$13.730
EPS growth	7.1 cents	3.3 cents	2.8 cents

In the last two quarters, CAG has pointed to half its pricing gain being due to lower trade promotion spending. Pricing was up 360bp in 3Q and 150bp in 2Q. On the 1Q call, they quantified the cut as 70bp of the 410bp pricing gain.

CAG is pointing to the $7.8 million increase in traditional marketing as proof it is investing in its brands again. That was a 1.2-cent headwind to EPS in the quarter. We are looking at the full picture and the $45 million cut in promotional spending added 7.1-cents to EPS for a net benefit of 5.9-cents for a company that beat by 1-cent.

We think CAG is still underspending on traditional marketing. Before CAG owned *Birdseye* and the other parts of Pinnacle, it was spending $80 million per quarter, now it's cheering $73 million? Every $6 million of higher spending is a 1-cent headwind to EPS. If the trade promotion normalizes, CAG has some significant headwinds on pricing for the next four quarters, which will hurt EPS, and revenue growth. It is also likely to create a picture where it appears CAG is not getting enough pricing to offset commodity inflation and it will translate into margin pressure.

Is 2022 and 3-year Guidance a Warning?

We think the company's fiscal 2022 guidance points to sales growth from COVID being over as the company is calling for only 1%-2% organic sales growth on a three-year CAGR ending in May 2022 that will include the recent COVID organic growth figures:

Organic Growth	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Volume	6.1%	6.6%	10.9%	21.0%	-1.3%	1.0%	-2.5%
Price	3.6%	1.5%	4.1%	0.5%	-0.4%	0.6%	0.8%
Organic Growth	9.7%	8.1%	15.0%	21.5%	-1.7%	1.6%	-1.7%

The fiscal 2020 figures pre-COVID had 2Q20 with 1.6% growth that came against a horrendous 2Q19 when volume growth was -2.2% and organic growth was -1.6%. Adding COVID demand with no discounting, panic buying, followed by shelf restocking into the 3-year figure and they still only plan to hit 1%-2% growth is another illustration to us that CAG simply doesn't grow. If CAG has to add back trade promotion spending too – which again cuts organic sales growth via reduced pricing – fiscal 2022 that could become a big drag. Having one-third of twelve quarters with growth at 10%- 20% in that CAGR should be enough to hold the growth rate higher than 1%-2%.

Guidance for fiscal 2022 also calls for an adjusted operating margin of 18%-19%. YTD in 2021, the adjusted margin is 18.6%. However, let's again look at marketing issues. If marketing should at least be at 2018 levels from the table in the previous section, CAG picked up $36.2 million in operating income from cuts in this area. Plus, it picked up $83.9 million from lower trade promotion that would cut sales and operating income. Just adjusting for the marketing, CAG's adjusted operating margin falls from 18.6% to 17.4%. The lack of travel expense that should return would cost another 16bp.

Investors should also consider that foodservice sales could also build back up going forward, but this is a lower margin business for CAG. Historically, it is 9%-10% of sales and the operating margin is 10%. With COVID restaurant closures and seating capacity restrictions, foodservice has only been 7% of sales as people eat at home more. We believe the lost restaurant sales went to grocery stores where CAG's margin has been over 24% for grocery and 20% for frozen food during COVID. A quick "back-of-the-envelope" analysis illustrates that moving 3% of total company sales from 20% margin to 10% margin business would cost total margins about 30bp.

At the same time, CAG has enjoyed margin gains during COVID due to high volume demand that allowed it to run production full-out and leverage fixed costs more. That's a huge change for a company whose best quarter of volume growth in the two years before COVID was 1.2% and there were six quarters of negative volume growth. CAG added 130bp of gross margin through the first three quarters of fiscal 2021. Here is where that came from:

- Massive panic buying by customers – volume gains of 21% and 11% to start COVID
- Retailers restocking inventory after the panic – volume gains of 6%+ the last two Q's
- Lack of trade promotion discussed above

- No mark-downs of prior excess inventories – Investors should remember how ugly CAG was pre-COVID. Not only was it taking impairments on brand assets and losing market share with negative volume figures, but it was carrying over 105 days of inventory – about 20-25 days too much. COVID cleared that overhang at full price.

With all that operating leverage going on and lack of mark-downs – CAG is only at their guidance figure for fiscal 2022, they are not crushing that figure at all. Yet, we see 166bp of pressure from marketing, travel, and the return of foodservice sales. Even CAG is forecasting negative volume growth after COVID and that should unwind some operating leverage. Kroger's inventory may only be light by about 1 day of sales versus 3 days last summer so CAG sales to restock the channel are unlikely to be as strong. CAG is highlighting that it can grow its own inventories back to maintain operating leverage. Inventories were about 10 days light at the end of last quarter at 72 days vs. 82 the prior two years. There are two points there. First, the 82 days was likely a bit high already given the problems that were building with CAG's inventories as it was cutting guidance at that time. Second, the 72 days is being viewed against strong sales growth that is expected to turn negative. Negative growth will push the DSI figure up without building more inventory.

Finally, let's keep in mind that commodity pressures are growing and while CAG is working to boost pricing its margin gains are stalling. The 130bp of margin gain YTD was only 10bp in 3Q.

	3Q21	2Q21	1Q21
y/y Gross Margin gain	12bp	130bp	244bp
Price/Productivity/Synergy	460bp	440bp	610bp
Price/Prod/Syn w/o Promotion	280bp	365bp	540bp
COGS Inflation	270bp	200bp	220bp

- Keep in mind the pricing/productivity/synergies have been helped by lower trade promotion. We adjust for that in the third line 180bp in 3Q as discussed previously

- CAG's spread between cost savings and pricing vs. inflation was only 10bp last quarter.

- CAG guided on the call that it will seek to recover inflation but it will be on a lagging basis – which to us means gross margin could decline.

- The primary retailers like Kroger and Walmart and now Amazon as CAG touts digital sales – push back on price increases and customers can still trade down to store-brands and keep total spending lower.

- All of this points to lower margins too.

The only positive we can see to all these normal operating costs and pressures returning after COVID is CAG may see lower COVID-related costs. These have been about 100-120bp of headwind on margins. However, a fair amount of COVID costs are higher wages for employees – good luck taking that back. In the 3Q, CAG labeled another 60bp of headwind from higher freight costs to get more volume to market. Maybe CAG picks up 50-70bp of margin with lower COVID costs and selling less volume means it doesn't need as much in delivery costs. But are fuel prices going down? Trucking costs per unit could still rise in fiscal 2022 vs. 2021.

A forecast for flat margins looks very aggressive to us with over 200bp of normal operating items that should reverse and become headwinds.

Macquarie Infrastructure Corp. (MIC) Update

We will contibue to cover MIC without an EQ rating, but are removing it from our Focus List as a Top Buy given the limited upside.

Summary

MIC announced a deal this week to sell its Atlantic Aviation unit to KKR for $4.475 billion with assumed debt. That came in above our high-end estimate at 16.2x pre-COVID EBITDA. The deal is expected to close on or before December 6, 2021. The total cash inflow will be $3.525 billion with $3.298 billion going to the shareholders as $37.35 per share in cash

That still leaves MIC Hawaii, the gas utility to sell which could add $5-$6 to the proceeds for shareholders. There is still an incentive for management to have a deal in place this year and close no later than June 2022. Compared to the current $38.50 stock price, there's still a potential 10%+ return over the 12-months.

We are moving the rating to neutral as much of the news is now out and the stock price responded favorably. The nature of the new structure may cause many investors to sell their positions before having shares exchanged from a C-Corp to an LLC structure causing the spread to narrow more slowly on this deal.

The New Structure

- Shareholders have already voted on the new structure and approved it. MIC will wait until just before the KKR deal closes to implement the new structure. Thus until December, MIC should remain a C-Corp.

- A new LLC will be established, and shareholders will exchange shares in MIC the C-Corp for the same number of shares in the new LLC. MIC Corp will then distribute the ownership of MIC Hawaii – the gas utility up to the LLC. MIC Corp will then only own Atlantic Aviation and KKR will acquire the shares of MIC Corp from the LLC for $3.525 billion.

- Nearly all of the debt at the holding level of MIC Corp has been retired and the necessary cash is already in place to retire the small amount that did not tender in March.

- The transfer of MIC Hawaii to the LLC is expected to be a taxable event. It is also expected that shareholders in the LLC may have a tax payment if and when MIC Hawaii is sold and the deal completed. The main purpose of setting up the LLC is to make the much larger distribution of Atlantic Aviation's sale tax-free to shareholders and making the taxable impact only affect the smaller Hawaii unit.

What is Different?

- The cash flow being generated during 2021 is being produced only at Atlantic Aviation and at MIC Hawaii and the bulk of that is at Atlantic Aviation. Guidance from MIC was for $130-$160 million in Free Cash Flow from these entities in 2021. Originally, we speculated that 2021 cash flow could also be distributed to shareholders as deals were closed (or would result in higher net of cash prices for the operating companies.)

- With KKR buying MIC Corporate, KKR will essentially keep any of the cash that accumulates at Atlantic Aviation from the time of the purchase agreement until the transfer is complete. Thus, KKR is putting in $3.525 billion in cash and assuming about $1 billion in debt. If Atlantic has $40 million in cash on hand at closing or $100 million – that stays with KKR.

- However, because KKR is acquiring MIC Corp and MIC Corp is the source of cash via Atlantic Aviation to pay for all these transactions, legal bills and tax events – MIC shareholders will benefit by having KKR fund these costs.

- This makes the remaining distribution largely the $37.35 in cash from KKR plus the value of MIC Hawaii when it is sold and distributed.

What Is the Value of MIC Hawaii?

- MIC purchased Hawaiian Gas in 2005 (closed in 2006) for $238 million with $34 million extra for working capital and transaction costs. At the time, EBITDA was $26 million per year for a multiple of 9.5-10.5x EBITDA.

- MIC has expanded the gas company over the years and on a pre-COVID basis it has been generating about $60 million in EBITDA fairly consistently. From 2015-2019,

EBITDA had a range of $59-$63 million. Much like Atlantic, we expect the Hawaiian Gas unit to be priced on pre-COVID figures.

- MIC Hawaii has also paid off more than half of its debt in April 2021. Total debt is now $93.5 million. When we last ran an estimate on the valuation, debt was $193.5 million. With many of the tax issues and transaction costs of distributing the gas unit up to the LLC now part of the KKR deal, the value of MIC Hawaii should be greater now:

Value of MIC HI at Multiple of:	**9.0**	**9.5**	**10.0**	**10.5**	**11.0**
Enterprise Value on $60mm EBITDA	$540.0	$570.0	$600.0	$630.0	$660.0
Less Debt	$93.5	$93.5	$93.5	$93.5	$93.5
Equity Value	$446.5	$476.5	$506.5	$536.5	$566.5
6.1% to Management Fee	$27.2	$29.1	$30.9	$32.7	$34.6
Value to shares	$419.3	$447.4	$475.6	$503.8	$531.9
Value per share (assume 89mm shares)	$4.71	$5.03	$5.34	$5.66	$5.98

- Under our prior update, we were valuing the MIC Hawaii at $3.44 per share. That assumed an additional $100 million in debt and a tax payment of $85 million. We believe the tax payment will come in much lower than that on the transfer and the additional debt has been repaid. It now looks like $5-$6 is a more reasonable forecast.

- Additional consideration – management can earn a $25 million bonus if they can have deals in place to sell both Atlantic Aviation and MIC Hawaii before the end of 2021 and have both deals close by June 2022. It is expected to require as long as a year to get the Public Utility Commission in Hawaii to sign off on the transfer, so the catalyst of announcing a deal for MIC Hawaii could happen during the summer of 2021. We are not certain if the $25 million bonus fee was set aside with the sale of IMTT already or if that would come out of the sale of MIC Hawaii. If the later, that would lower the proceeds to shareholders by 28-cents per share.

- The conclusion for MIC Hawaii is it could be worth about $5 per share +/- $1, which along with the $37.35 for Atlantic Aviation is $41.35-43.35. That is a 7.4%-12.6% return from today's price in less than a year. If a deal for MIC Hawaii is announced this summer, there could be one more pop in the stock toward these levels fairly soon. If it takes longer, the risk return may not be as compelling. That is why we are moving this to a neutral.

Behind the Numbers 2Q ’21 Focus List

Top Sells

Company	EQ Rating	Date Added	
Altria Group (MO)	3- (Minor Concern)	6/11/2021	p.15
Conagra Brands, Inc. (CAG)	2- (Weak)	3/12/2021	p.17
Equinix, Inc. (EQIX)	3- (Minor Concern)	4/30/2021	p.18
International Business Machines Corporation (IBM)	2- (Weak)	3/12/2021	p.19
Iron Mountain Incorporated (IRM)	1- (Strong Concern)	12/4/2020	p.21
Keurig Dr Pepper Inc. (KDP)	2+ (Weak)	12/4/2020	p.22
Mondelez International, Inc. (MDLZ)	2+ (Weak)	12/4/2020	p.23
Patterson Companies, Inc. (PDCO)	2+ (Weak)	3/12/2021	p.24
Sysco Corporation (SYY)	3- (Minor Concern)	6/11/2021	p.25
Sealed Air Corporation (SEE)	2+ (Weak)	12/4/2020	p.26
TransDigm Group Incorporated (TDG)	2+ (Weak)	3/12/2021	p.28

On Deck Sells

Company	EQ Rating	Date Added	
Ball Corporation (BLL)	3- (Minor Concern)	3/12/2021	p.29
Henry Schein, Inc. (HSIC)	3- (Minor Concern)	3/12/2021	p.31
TreeHouse Foods, Inc. (THS)	3- (Minor Concern)	3/12/2021	p.33

Top Buys

Company	EQ Rating	Date Added	
Air Lease Corporation (AL)	4+ (Acceptable)	12/4/2021	p.34
AT&T Inc.(T)	4+ (Acceptable)	3/12/2021	p.35
Mowi ASA (MHGVY)	*4+ (Acceptable)*	12/4/2021	p.36
National Instruments Corporation (NATI)	*5- (Strong)*	3/12/2021	p.37
Texas Instruments Incorporated (TXN)	*5+ (Strong)*	3/12/2021	p.38
UnitedHealth Group Incorporated (UNH)	*5- (Strong)*	3/12/2021	p.39

Summary of Changes to the 2Q'21 BTN Focus List During the Quarter

Added to Top Sells

Altria Group (MO)	Added 6/11/2021	p.15
Sysco Corporation (SYY)	Added 6/11/2021	p.25
Equinix, Inc. (EQIX)	Added 4/30/2021	p.18

Removed from Top Buys

Macquarie Infrastructure Corporation (MIC)	Removed 6/11/2021	p.35

Removed from "On Deck" Buys

Ares Capital (ARCC)	Removed 4/30/2021	p.40
Starwood Property Trust, Inc. (STWD)	Removed 6/11/2021	p.40

Overview of the BTN Focus List

Our foundational belief at Behind the Numbers is that earnings quality matters. We believe that companies that are resorting to increasingly aggressive accounting such as slashing reserves, taking never-ending restructuring charges, or extending depreciable lives to meet earnings estimates will eventually face a day of reckoning in the form of an unexpected earnings disappointment. Likewise, companies with hidden assets, conservative accounting, or non-operational headwinds that will reverse are likely to produce better than anticipated results. This has been borne out time and again by academic research.

While our Earnings Quality ratings express our level of concern with the reliability and sustainability of a company's reported earnings and cash flows, they do not consider more fundamental factors such as valuation, sources of recent revenue growth, upcoming difficult comps, or other factors which might make an idea timelier. The *BTN Focus List* addresses this by documenting which companies under coverage we believe are getting closer to the point of materially underperforming or overperforming.

The list is divided into Top Sells and Buys along with an "On Deck" list of companies we believe have compelling points but may not warrant being on the top lists due to valuation factors. We will continue to publish the Focus List quarterly and will notify clients of the additions and subtraction to the list made during the quarter by e-mail.

Top Sells

Altria Group, Inc (MO)- Top Sell

Date Added	6/11/2021
Market Cap	$92 B
Target Price	$
PE (fwd)	11
Short %	0.76
Current EQ Rating	3-(Minor Concern)

We are adding moving MO to the Top Sell list as we believe the company has been a major beneficiary of smokers who were working from home having more opportunity to smoke. However, this is already reversing and many other problems remain:

- MO's 1Q21 looked like we anticipated with smoking volumes dropping 2% which was an acceleration of the decay from the prior two quarters. We still believe MO was a major beneficiary of the pandemic as people working from home could smoke more often. Going forward the comps get tougher for smoking and that is still the primary driver of MO's results. With the volume decay resuming, adjusted EPS fell 2-cents y/y as revenue declined 4.6% for smokable products and operating income was down 0.7%. We believe decay rates will exceed -5% during 2021.

- MO has been very clear that gasoline purchases eat into the smoker's disposable incomes. On a y/y basis, smoking will face comps where customers bought far lower volumes of cheaper gasoline.

- The pandemic likely masked the impacts of the federal law raising the age to buy cigarettes to 21 as 2020 began. Altria had been posting 7% declines in volume leading up to this law for several years. What is worse than that is a -7% is a net figure of lost volumes from existing smokers offset by higher volumes from new smokers. Over 95% of smokers who start do so before age 21. Thus, we think the COVID tailwind was enormous for MO. If the normal range was -10% in smoking volumes + 3% new smokers for a -7% rate, then posting a -1% in 2020 without the +3% of new smokers is incredible. (We are using the +3% figure of new smokers just for illustration of what is happening – that figure is not quantified.). In 2021, if existing smokers buy/smoke less due to a return to life of smoking restrictions returning to normal and coffee and gasoline purchases competing against cigarettes – and the new youth smokers aren't entering the market –

it could be a sizeable drop-off in volumes against tough comps. Remember, MO was posting -7%'s on top of -7% comps from the prior year coming into COVID without the minimum 21-year age requirement to buy cigarettes.

- The potential menthol ban is becoming a bigger news item as the FDA is proposing it again. 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, plus 13 in Minnesota too. Early in 2021, 23 state attorneys general asked the FDA to ban menthol. The move towards a ban is hardly at step one with years to go until a ban, as the industry contends. 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.

- Graphic packaging continues to move forward. The FDA wants the companies to submit their plans to deal with the new graphic packaging by June 14, 2021. The new labels are required by federal law and have been mandated in court. They go into effect in early 2022. However, we believe there will be more news in this area throughout 2021 with the new health warnings shown on TV and newspapers. It should start becoming part of future earnings forecasts too. Numerous studies have found the photos and larger warnings have been universally successful in getting more smokers to quit and others to smoke less. It also has been effective in preventing new smokers from starting. That has been the case in 125 countries that already have this type of packaging in place. A pack of cigarettes is something the smoker sees 20x every. We see this as something that will experience volume decay gap down even faster and some impacts could be seen in 2021.

- We believed in 2017 that the cut in the corporate tax rate from 35% to 21% gave MO a reprieve from cutting its dividend. That was worth more than $1 billion in extra cash flow per year. The company spent it boosting the dividend further. If rates increase by 500bp again, it would cost MO about $500 million in cash flow. If smoking income falls by 5%, that's another $400 million. Cash flow and EBITDA growth have also benefitted from restructuring and cost-cutting which may also be muted going forward.

- 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 but we still expect an eventual write-down. MO claims the BUD decline is temporary, but the stock was down long before COVID. It is very easy to compare BUD's publicly traded stock price to the carrying value to assess for impairment.

Conagra Brands, Inc. (CAG)- Top Sell

Date Added	3/12/2021
Market Cap	$18 B
Target Price	$27
PE (fwd)	15
Short %	2.6%
Current EQ Rating	2- (Weak)

We downgraded our earnings quality rating to 2- (Weak) after the 3/21 quarter.

- We think investors should remember just how poor results were at CAG in the Pre-COVID days. It continually restructured – which is still going on – and touted that it picked up 400bp of margin gains. Nearly all of that came from divesting lower margin units and cutting advertising. The company rarely posted positive volume growth and conceded sales to gain some pricing. This led to double-digit declines in sales for key products like *Marie Callender's, Hunts Tomatoes, Wish-Bone* dressing, and even *Birdseye* as store brands and competitors did not raise pricing at the same rates.

- COVID bailed out CAG as its inventory levels crept higher and higher on weak sales and could have led to mark-downs to clear stocks. CAG had warned it would take years to correct these issues. COVID drove a 21% volume growth quarter followed by 15% which allowed all the inventory to be cleared without hefty mark-downs and helped CAG's margins. It then enjoyed a couple of quarters of above-average growth to restock depleted inventory channels. In the two years before COVID, CAG posted two quarters with 1% volume growth – both came against horrifically negative comps the year before.

- CAG cut advertising for years to help EPS and during COVID it was able to reduce trade promotions too that are accounted for as reductions to sales. In fiscal 3Q21, reduced trade promotions added 180bp to net sales growth and 7.1 cents to EPS – CAG only beat by 1-cent. Going forward, CAG should see trade promotion increase again. Total marketing cuts in fiscal 2021 so far have added 120bp to CAG's operating margins.

- CAG is guiding investors to expect it to hold current margins in fiscal 2022. We see marketing and travel costs as headwinds along with a return of more restaurant sales which are half the margin of grocery sales. Any routine discounts to replace an older product with a new one could pressure pricing as it always did historically. Even CAG forecasts negative volume growth that could unwind operating leverage and hurt margins along with commodity inflation that is already eliminating gross margin gains.

Equinix, Inc. (EQIX)- Top Sell

Date Added	4/30/2021
Market Cap	$73 B
Target Price	$450
P/FFO (fwd)	43
Short %	1.0%
Current EQ Rating	3- (Minor Concern)

We added EQIX to our Top Sell list on 4/30/2021.

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.

International Business Machines Corporation (IBM)- Top Sell

Date Added	3/12/2021
Market Cap	$133 B
Target Price	$90
PE (fwd)	14
Short %	2.8%
Current EQ Rating	2- (Weak)

We maintained our earnings quality rating of 2- (Weak) after the 3/21 quarter.

IBM's non-GAAP EPS of $1.77 beat estimates by 12-cents in 1Q21. We found several non-recurring items that were material benefits to results and account for far more than the EPS beat. IBM did not expand annual guidance after the quarter despite the 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 it 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 the pandemic started and we would expect this to become a headwind for IBM going forward.

- 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 reflected 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.

- While not quantified, IBM also benefited in 1Q21 from lower travel costs and lower COVID costs as well. For all the talk about IBM cutting costs, we see that SG&A costs were essentially flat y/y if we adjust for the items above. SG&A expense was $5,174 million vs. $5,212 million in the year-ago quarter and lower COVID and travel costs may have accounted for that. 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. R&D was basically flat y/y in 1Q21 and down slightly as a percentage of sales. But it looks to us like non-GAAP EPS is gaining about 40-cents per quarter because IBM is ignoring the cost of buying the new technologies.

- Direct Finance Leasing appears to have benefitted by an unusual drop in cost of inventory which we believe could have added 7 cps and a large part of the reported increase in total company gross margin.

- Reworking contracts in the GTS unit added about 4 cps to EPS. The improvement in this area declined from the 4Q despite being in effect the entire quarter.

Iron Mountain Incorporated (IRM)- Top Sell

Date Added	12/4/2021
Market Cap	$14 B
Target Price	$18
P/FFO (fwd)	17
Short %	12.3%
Current EQ Rating	1-(Strong Concern)

We maintained our earnings quality rating of 1+ (Weak) after the 3/21 quarter.

- IRM beat forecasts for FFO by 7-cents and the company raised the high-end of guidance by essentially 1% in all areas such as Revenue, EBITDA, and AFFO. The higher guidance is being driven by acquisitions. The FFO beat includes 4-cents added back from stock compensation under IRM's newly changed definition of FFO. It had another 4-cents from not adjusting for financing lease principal payments.

- IRM benefited from a lag in expense lag of returning to normal post-COVID with items like transportation being down $8.1 million y/y. However, it saw the service side of records management start to normalize later in 1Q and sales commissions were up. Furloughed employees are still returning so labor was down $14.5 million but should likely grow going forward. Every $4 million of costs like this is worth about 1-cent in FFO. Even Information Technology Costs grew during COVID in 2020. In 1Q21, those costs were down $1.8 million. According to IRM, it expects to see margin pressure of 200-300bp in 2Q and 3Q and then deliver a back-loaded benefit in 4Q to hit forecasts. 200-300bp of margin is 6-9 cents of pressure on quarterly FFO. That guidance would seem to indicate that many of these timing differences between returning revenues and costs should reverse from 1Q21 through the fall.

- Overall, we still believe IRM is touting growth but ignoring the costs to get that growth including picking up and delivering data files, commissions paid to bring in business, buying out existing contracts at competitors, offering below-market rates as initial inducements, and low maintenance capital spending. The cash flow statement shows many of these extra ongoing costs and paints a much weaker picture than the REIT stats IRM uses.

Keurig Dr Pepper Incorporated (KDP)- Top Sell

Date Added	12/4/2021
Market Cap	$50 B
Target Price	$19
PE (fwd)	22
Short %	4.9%
Current EQ Rating	2- (Weak)

We maintained our earnings quality rating of 2- (Weak) after the 3/21 quarter.

- Payables rose again to 271 days in 1Q21, up from 252 days in 4Q. The factored payables are now $2.8 billion and are excluded from KDP's debt. The company touts a debt/adjusted EBITDA of 3.5x. Adjusting for payables the ratio is 4.3x. Also, the adjusted EBITDA adds back many recurring items such a non-routine legal bills, stock compensation, integration charges, restructuring, and productivity plans. The ratio jumps to 4.7x if these are considered recurring expenses.

- Cash flow rose $132 million and KDP picked up $131 million from extending payables further. It also picked up $15 million from having finance leases with the principal payment in the financing section.

- Marketing spending is not growing yet after falling by $200 million in 2020. This is still adding about 2.5-cents per quarter to EPS. If the marketing was at normal rates, the debt/EBITDA ratio would be 5.0x.

- A lower tax rate added 1.2 cents more and is not expected to repeat. KDP beat by only 1-cent.

- Coffee sales benefitted from higher equipment sales with COVID, an easy comp, and stocking coffee pods. The company noted that the 14% pod volume was closer to 3% adjusting for these factors.

- Another secondary stock offering is coming as MDLZ sells more of its stake. This is the third in less than a year.

Mondelez International, Inc. (MDLZ)- Top Sell

Date Added	12/4/2021
Market Cap	$89 B
Target Price	$42
PE (fwd)	22
Short %	1.0%
Current EQ Rating	2- (Weak)

We maintained our earnings quality rating of 2- (Weak) after the 3/21 quarter.

- 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.

- 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 declining volumes. 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. This dynamic has continued for years and is not related to COVID.

- 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 boost EPS.

- Gross margin was 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.

- While Easter was in 2Q, it occurred on April 4 and thus some revenues were likely pulled into 1Q21

Patterson Companies Incorporated (PDCO)- Top Sell

Date Added	3/12/2021
Market Cap	$3 B
Target Price	$23
PE (fwd)	17
Short %	9.9%
Current EQ Rating	3- (Minor Concern)

We maintained our earnings quality rating of 3- (Minor Concern) after the 1/21 quarter.

- Of the $95 million in sales growth in the 12/20 quarter, $33 million came from higher COVID-related supplies. We expect sales of these products such as hand sanitizers and cleaning products will evaporate going forward as they become fully available in retail channels again.

- Another $69 million in new sales was generated by animal consumables driven by channel stocking new products and a pandemic-induced surge in pet adoptions. Animal-related sales rose 8.5%- it is usually 3%.

- Operating margin improved by 30 bps. However, one-time factors added 31 bps including lower depreciation (7 bps), lower stock compensation (6 bps), and lower legal and travel expense (18 bps). Margins were also helped by a mix shift to higher-margin private label products as well as hitting rebates. All things considered, we see the margin improvement as disappointing.

- PDCO's operating margin is less than 5%, the gain from selling receivables can materially impact results and has amounted to more than +50bps in the past.

- Selling more private label products could hinder PDCO's ability to capitalize on supplier rebates which have been a big part of the company's earnings in the past.

Sealed Air Corporation (SEE)- Top Sell

Date Added	12/4/2021
Market Cap	$9 B
Target Price	$32
PE (fwd)	16
Short %	1.9%
Current EQ Rating	2+ (Weak)

We raised our earnings quality rating to 2+ (Weak) after the 3/21 quarter.

- SEE beat forecasts by 6-cents and boosted guidance after the 3/21 quarter. We think the beat was helped by SEE not increasing expectations after it gained volume from COVID vaccine shipping containers in 4Q20. That seems to account for much of the outperformance and we would question how sustainable that is. That was 2-cents in 4Q and may have been more than 4-cents in 1Q.

- We also think the price/cost headwind was lighter than many expected at -$18 million in 1Q. Another $5 million would have cost SEE 2-cents in EPS and SEE is still +$160 million with customers in this area. This makes us skeptical the company will be able to raise prices quickly enough to cover rising costs. For example, LYB was forecasting a $300 million per ton increase in plastic prices in May.

- SEE also incurred 3-cents per share in expenses paid to third-party consultants working on the restructuring which was added back to non-GAAP results.

- Combining the South American reporting unit with North America allowed the company to post artificially high pricing growth in that segment.

- The tax dispute with the IRS over disallowing a $1.49b loss from prior taxes is moving to the appeals process and the IRS asked for more information before starting. SEE continues to point out this could have a material negative impact on results within the next 12- months. It would be a $525 million cash item, or about 6-months of EBITDA.

- We note that vaccines will post strong volume in 2Q21 and SEE has very easy comps from 2Q20.

Sysco Corporation (SYY)- Top Sell

Date Added	6/11/2021
Market Cap	$41 B
Target Price	$65
PE (fwd)	59
Short %	1.2%
Current EQ Rating	3- (Minor Concern)

We are adding SYY to the Focus List as a Top Sell.

SYY has seen its stock price skyrocket on expectations of supercharged growth from consumers returning to dining out in the post-pandemic environment. Indeed, SYY should experience strong growth against easy comps in the next couple of quarters. However, we would argue that the current valuation of almost 22 times pre-pandemic non-GAAP earnings reflects this. The 2015 antitrust block of its proposed acquisition of US Foods marked the end of its growth through acquisition days. Since then, the company has often struggled to post low single-digit revenue growth with food price inflation often providing much of the growth. While it did gain market share during the pandemic against smaller players, we believe much of this will quickly be given back as restaurants will always want to diversify their supplier base.

Also, SYY has a history of reporting results with unusual items that allow it to top estimates. The last quarter was no exception. 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/expense 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 was 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.

TransDigm Group Incorporated (TDG)- Top Sell

Date Added	3/12/2021
Market Cap	$33 B
Target Price	$480
PE (fwd)	52
Short %	3.5%
Current EQ Rating	2- (Weak)

We raised our earnings quality rating to 2+ (Weak) after the 3/21 quarter.

- TDG added back $18 million in COVID-related 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.

- 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 the pandemic companies were given a two-year reprieve where they could shield 50%. This already drove the 3/21 quarter effective tax rate to 19.6% from 4.2% y/y largely as a result of section 163(j). We estimate this will be about 20-30-cents in EPS per quarter this year. This effectively reduces ROI and the amount of debt TDG can carry.

- TDG has debt of 8.3x trailing 12 months adjusted EBITDA and using a pre-COVID EBITDA, it is still 6.7x.

On the positive side:

- 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. This could help boost gross margin in the short run. 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.

- On the positive side, TDG thinks the audit into defense contract pricing is going smoothly and similar in scope to prior audits.

“On Deck” Sells

These are companies under coverage with material problems but are not currently on the Top Sell list due to valuation or timing factors.

Ball Corporation (BLL)

Current EQ rating: 3- (Minor Concern)

We maintained our earnings quality rating of BLL at 3- (Minor Concern) after the 3/21 quarter.

BLL’s stock has taken a hit in the last few days after a competitor announced plans to build more capacity in North America. BLL is currently in the process of expanding its own capacity by 25% from 2019 levels and we remained concerned that if the demand/supply conditions do not allow the company to sell incremental product as planned it could result in the company being delayed in paying off its rising debt load.

- 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, Georgia 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.

Henry Schein, Inc. (HSIC)

Current EQ rating: 3- (Minor Concern)

We maintained our earnings quality rating of 3- (Minor Concern) after the 3/21 quarter.

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. Test kit sales 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-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 foreshadow 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.

TreeHouse Foods, Inc. (THS)

Current EQ rating: 3- (Minor Concern)

We cut our earnings quality rating to 2- (Weak) after the 3/21 quarter.

- THS beat non-GAAP EPS by 3-cents in 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 of COVID-related costs, 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 earned about $2.50 pre-COVID and its COVID cost figures are rising from 9-cents in 3Q20? We are not seeing other companies reporting that percentage of earnings going to COVID response. 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-driven 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.

Top Buys

Air Lease Corp. (AL)- Buy

Date Added	12/4/2021
Market Cap	$6 B
Target Price	$65
PE (fwd)	11
Short %	5.9%
Current EQ Rating	4+ (Acceptable)

We maintained our earnings quality rating of 4+ (Acceptable) after 1Q results.

- After 4Q20 results, AL guided investors to expect more lease deferral requests in early 2021. However, the drag from moving more leases to recognizing revenue when cash is received was 43 cps versus 19 cps in 4Q. Despite this, AL still only missed EPS estimates by a penny. 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.

- 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 reduce 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 leases are being signed at pre-COVID contracted rates.

AT&T Inc. (T)- Buy

Date Added	3/12/2021
Market Cap	$207 B
Target Price	$40
PE (fwd)	9
Short %	1.7%
Current EQ Rating	4+ (Acceptable)

We could not be more pleased with T unlocking the undervalued parts of its business. Investors are giving up 88 cps in annual dividends, but they are getting:

- 71% of NewCo which we value as high as $10 per share.
- Growth at NewCo which should drive further capital appreciation.
- Debt reduction at T which we value at $2.60 per share.
- Benefit of maintaining HBO Max bundling deal.
- More investment in T's core business to drive future growth

We have contended that the sum of the parts amounts to at least $40. This transaction moves the company closer to realizing this value.

Macquarie Infrastructure Corporation (MIC)- Remove from Top Buy

We are removing MIC from our Top Buy list.

MIC announced a deal this week to sell its Atlantic Aviation unit to KKR for $4.475 billion with assumed debt. That came in above our high-end estimate at 16.2x pre-COVID EBITDA. The deal is expected to close on or before December 6, 2021. The total cash inflow will be $3.525 billion with $3.298 billion going to the shareholders as $37.35 per share in cash

That still leaves MIC Hawaii, the gas utility to sell which could add $5-$6 to the proceeds for shareholders. There is still an incentive for management to have a deal in place this year and close no later than June 2022. Compared to the current $38.50 stock price, there's still a potential 10%+ return over the 12-months. We are removing MIC from our Top Buy list due to the decreased upside potential.

Mowi ASA (MHGVY)- Top Buy

Date	12/4/2021
Market Cap	$14 B
Target Price	$29
PE (fwd)	
Short %	-
Current EQ Rating	4+ (Acceptable)

We maintained our earnings quality rating of 4+ (Acceptable) following the 3/21 quarter results.

- Despite the company having its largest first-quarter harvest ever, demand growth (15.9%) exceeded supply growth (14.4%). The 1Q harvest was unusually large from timing issues and full-year supply growth estimates remain subdued at 1-4% growth.

- Prices started the quarter at €4/kg and finished at approximately €7/kg. This trend should continue. The company continues to target €25 million in cost reductions on top of €35 million realized after 2020. This could add 10% to pre-pandemic earnings and help drive dividend growth. The company has also recovered most of the COVID-induced write-down of its fish in sea pens

- Management plans to pay 50% of earnings as a dividend. The dividend has already been raised to 9 cps from 4 cps and the company has yet to see a full quarter with salmon at the higher price level. We could easily see the dividend top 20 cps which leaves significant upside left from the current stock price.

National Instruments Corporation (NATI)- Buy

Date Added	3/12/2021
Market Cap	$5 B
Target Price	$50
PE (fwd)	29
Short %	2.6%
Current EQ Rating	5- (Strong)

We maintained our EQ rating of 5- (Strong) following the 3/21 quarter results.

- NATI's non-GAAP EPS of $0.32 beat forecasts by a penny. A lack of travel expenses added 3 cps to EPS which was offset by a 3 cps jump in variable compensation. We expect both situations to reverse and continue to cancel each other out. Variable compensation was $8 million in 1Q21 vs. $3 million in 1Q20 and for all of 2020, it was only $8 million.

- Sales growth was dampened by a shortage of parts in the supply channel. Carryover from this and the associated margin deleveraging could make for a tough second quarter. However, the rising backlog will eventually be realized and increase visibility for sales in the third and fourth quarters. The restructuring is now complete and will add as much as 10 cps to quarterly EPS. Rebuilding inventories should help boost gross margin in the second half. We expect the spread between GAAP and non-GAAP results to narrow, increasing earnings quality.

Texas Instruments Incorporated (TXN)- Top Buy

Date Added	3/12/2021
Market Cap	$172 B
Target Price	$200
PE (fwd)	25
Short %	1.3%
Current EQ Rating	5+ (Strong)

We maintained our earnings quality rating of 5+ (Strong).

- TXN maintains higher inventory levels as a matter of practice. The company uses a consignment method for inventory held at distributors under which the inventory stays on TXN's books. This is conservative as TXN cannot artificially boost sales by "stuffing the channel."

- Higher inventory also allows the company to have product available when competitors do not and producing at higher volumes keeps cost per unit low. This worked well in the fourth quarter as strong demand caused a sales upside and sizeable margin leverage.

- The company consistently spends generously on R&D which allows it to remain competitive.

- Acquisitions are few and far between and intangibles are not a material part of the balance sheet. If TXN amortized goodwill over 40 years it would only penalize EPS by about 2%. That compares to around 30% for most chip makers.

UnitedHealth Group Incorporated (UNH)- Top Buy

Date	6/11/2021
Market Cap	$379 B
Target Price	$380
PE (fwd)	22
Short %	0.7%
Current EQ Rating	5- (Strong)

- DSOs on rebates are improving. During COVID, people skipped medical visits yet UNH accrued for rebates as it still collected premiums. This resulted in some non-cash earnings from rebates that were not collected but increased in Accounts Receivable. It is a minor amount and normally runs less than $10 billion with a DSO in the mid-teens. After peaking in 3Q19 at $13.2 billion (DSO of 23.7), it has dropped to $11.5 billion and 19.0 DSOs. That is boosting cash flow at UNH and we believe there may still be about $3 billion more of decline and released cash. Cash flow improved y/y in 1Q by $3 billion and about half of that was from working capital like these falling receivables.

- The ratio of medical costs to medical premiums has recovered from the impact of COVID. Normally it is about 81%. During COVID, it fell into the low 70% range as premiums were collected, but people didn't visit the doctor. It bounced higher in 3Q19 and 4Q19 (over 82%) as pent-up demand for medical care boosted costs while premiums didn't have a boost. 1Q21 saw the y/y ratio actually fall slightly from 81.0% (this first period of COVID) to 80.9%. 2Q21 should see a more normalized ratio vs. 2Q20's 70.2%, but thereafter, the ratio should decline y/y in 3Q and 4Q and help EPS growth. Every 10bp of improved margin in this area is worth about 4.5-cents in quarterly EPS. Expect headwind in 2Q, and perhaps 100bp of tailwind in 3Q and 4Q.

- As expected, the ACA tax expiration helped the tax rate drop from 24% to 21.5% y/y in 1Q. This added 16-cents to 1Q21 EPS. This should continue.

Ares Capital (ARCC)

Current EQ rating: 5- (Strong)

We discontinued coverage of ARCC on 4/30/2021 with an EQ rating of 4+ (Acceptable). We also removed ARCC from our Focus List where it was rated as an On Deck Buy.

Starwood Property Trust (STWD)

We are removing STWD from our On Deck Buy list as the stock is close to the top of our valuation range and we see limited upside. We maintain earnings quality coverage with a 5+ (Strong) rating.

- STWD highlighted in its March investor day how the floors on its floating rate loans help mute the impact of falling rates but still allow it to participate in a rising rate environment. Also, the company directly owns property which adds duration to its portfolio and allows it to collect rental income.

- Lending standards have increased significantly since 2009. Loan to values is limited to 60% versus 70% prior to the Financial Crisis. Only in-place rents are considered in evaluating loans and they are marked to market in the event of a sublease. Minimum debt service is 1.35-1.87x versus 1.05-1.35x before the crisis. Securitizations now have cash reserves and a guarantee from the sponsor and STWD hedges the interest rate risk and locks in the credit spreads.

- Liquidity remains strong and STWD as it maintains $250 million cash on hand. 45% of debt is unsecured or off-balance sheet. 75% has no margin calls. The duration of liabilities is 50 months versus 41 for mortgage assets which reduces refinancing risk. This also highlights STWD's use of A-Notes as financing over warehouse lines. For a typical commercial mortgage, it is 75% borrowed with 25% equity. STWD splits the 75% loan into an A-tranche of 56% and a B-tranche of 19%. It will then borrow against the A-tranche with A-Notes.

- STWD has $7 billion in liquidity now plus $3 billion in unencumbered assets. The goal going forward is to continue to boost unencumbered assets with more issuances of unsecured debt and securitizations to move debt off the balance sheet. We believe all of this activity continues to point to STWD's dividend being safe.

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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