BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Sealed Air Corp. – Neutral Rating

Sealed Air (SEE - $38.91) started out as an *EQ Review* report where we focus solely on the accounting for quality and sustainability. There were enough issues that caught our eye that we believed could make this a much larger story. After reviewing this more fully, we arrived at the conclusion that the basic operating model for SEE has several tailwinds helping it and the basic free cash flow generation is strong enough to sustain and grow the dividend.

However, there are still some significant risks here in our view including SEC and IRS issues. The timing of potential problems is unclear. Yet, we believe the potential for problems with foreign exchange, foreign operations, debt at about 4x EBITDA, working capital growth, full access to cash, make it tough to recommend owning this stock. There may be other ways to play the tailwinds that are working for SEE via other companies that may offer better value than a 1.6% dividend yield, low single-digit growth, trading for about 11x EBITDA.

The basic risks we believe investors should be aware of:

- **Why is growth so slow when end markets seem to have good growth potential such as packaging for e-commerce, increased demand for protein, and keeping fresh food viable longer?**

- **The IRS wants to deny a $1.49 billion payment to settle asbestos litigation made in 2014 and the SEC is asking for information regarding tax accounting. There are more than $200 million in other tax issues in dispute as well.**

- **Foreign operations and FX create several potential problems. FX changes are a big part of sales results; the stronger dollar may pressure pricing power for foreign sales where 49% of revenue originates. Several currencies have seen moves > than 10% twice in the last 3-years and several currencies are falling rapidly in 2018.** Accounting for rapidly depreciating currencies with an average FX change rate vs. end of the quarter pricing can overstate reported values in the financial statements.

- **FX has often had a larger impact on sales and EBITDA than price or volume changes at SEE. The company cannot always access cash from overseas and the majority of its debt is in US dollars. Servicing US dollar debt with depreciating foreign currencies can result in debt ratios looking worse very quickly.** That gets worse when the cash is not accessible. Even the company is reducing forecasts of FX and believes it will be a headwind. SEE has 3.7x EBITDA in debt.

- **Rising raw material costs are driving up working capital investments and hurting cash flow.** SEE is talking about customers asking for help on costs while at the same time it tries to push through price increases. Historically, volume gains and pricing gains are short-lived for SEE. We think the rising costs could squeeze margins and cash flow.

The Basic Model for SEE Has Cushion

Selling the Diversey unit for $2.2 billion in 2017 allowed Sealed Air to buy back a large amount of stock and retire some debt last year.

	1H18	2017	2016	2015
Repurchases	$408	$1,302	$217	$802
Price	162.5	188.9	197.2	206.7
EPS Growth from Repo	20.2%	4.4%	4.7%	

That is driving EPS growth of late. At the end of July, the share count was down to $158.8 million, so some of this should continue to help EPS growth.

From a cash flow standpoint, there is some solid cushion too in the near-term. SEE made two acquisitions in 2nd half of 2017 and another in August 2018. Those should add to cash flow this year so the company's forecast of $900 million in EBITDA is not a big stretch – unless some of the issues we discuss later really kick in over the next 5-months. Here is recent cash flow:

	2017	2016	2015
CFO	$424	$907	$982
Cap Ex	$184	$276	$184
Free Cash	$241	$631	$798
Dividend	$120	$122	$107
Adj. EBITDA	$833	$809	$850

In 2017, CFO was negatively impacted by taxes. In 2018, EBITDA is forecast to be $900 million, depreciation should be about $140, net interest about $180. SEE is guiding to a 28% tax rate which results in about $420 million in net income. Add back $140 in depreciation and subtract $160 in forecast capital spending and free cash flow is $400 million. That will easily cover a dividend on a lower share count of probably $110 million.

On the surface, there is some baked-in EPS growth and cash flow is solid enough to easily cover the dividend and show shareholders some yield. That may make this company overpriced, but not necessarily a short idea right now.

There are Tailwinds for Growth at SEE – It Should Probably Be Growing Faster

This is a company that sells packaging material for e-commerce shipping as well as general consumer packaging. The product care unit is just under 40% of sales and 40% of this unit is e-commerce and consumer packaging or 16% of total sales. SEE has a little over 60% of sales related to food care – extending life of packaged fresh food to reduce waste and

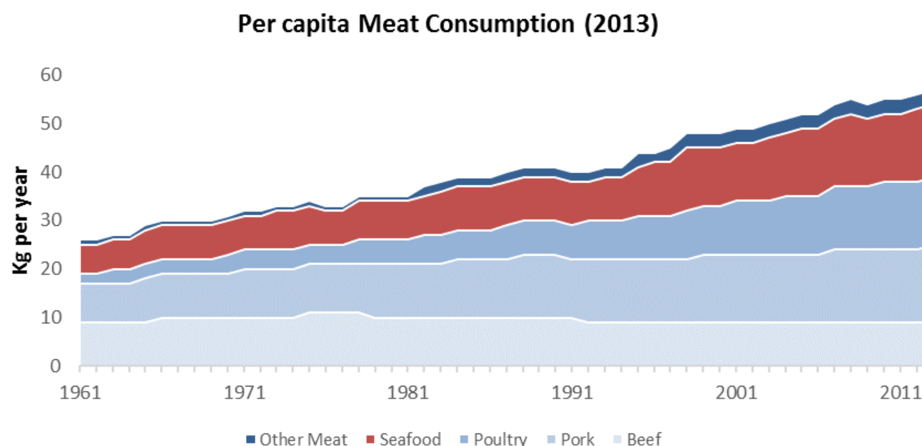
packaging red meat, poultry, fish, processed meat, cheese and dairy for 94% of that or 56% of total sales.

Most people are aware that e-commerce is growing rapidly. Here are the last few years of sales growth for Amazon both North America and International retail sales. This excludes the AWS cloud-computing unit:

AMZN Growth	2017	2016	2015
N/America	33%	25%	26%
International pre-FX	23%	26%	21%

We admit Amazon does not break this down by price vs. volume so people suddenly buying a dishwasher online instead of a $12 book can skew this growth rate higher. Also, since AMZN charges a percentage of sales commission to retailers using its platform but not having AMZN fulfill the transaction and thus only the commission is booked to sales, that would reduce the sales growth rate. Adding Whole Foods in 2017 helped as well. But, overall 25% growth is fairly strong. SEE does business with AMZN and the conference calls talk about working with AMZN to try to help it control the increasing costs of packaging and fulfillment.

Fresh protein sales are over half of total sales at SEE and these are growing too. Marine Harvest, the largest salmon farmer in the world, has this table in its industry handbook from the Food and Agricultural Organization of the UN. It shows that meat consumption worldwide is rising – especially fish, poultry, and pork:



This shows growth for over 50-years. Tyson Foods sells Beef, Pork and Chicken. For the last few years, they are still seeing volume growth for various proteins:

Tyson Foods	9m 2018	2017	2016	2015
Beef Vol.	3.0%	1.8%	0.8%	0.3%
Pork Vol.	-1.9%	0.6%	1.2%	5.4%
Chicken Vol.	3.1%	1.2%	-2.6%	4.2%

In fiscal 2015, Tyson had an extra week that helped 2015 and hurt 2016. But we believe the general trends in volume for protein consumption continue to rise.

So, let's look at this in general terms. If 16% of sales have a 25% tailwind, that's 4% growth – cut that in half and call it 2%. Another 56% of demand is growing at 2% or 1.1%. SEE should be posting essentially 3% sales growth from 72% of sales. The remaining 28% are related to industrial sales and other economically sensitive items. Given the turn in the economy, the remaining 28% could grow less than 2% and push total sales growth to 3.5% at SEE. SEE is running about half this rate:

SEE Growth	1H18	2017	2016	2015
Food Care Vol	1.9%	3.8%	0.9%	1.3%
Product Care Vol	1.6%	5.7%	1.4%	-1.9%
Total Volume	1.8%	4.5%	1.2%	0.3%

Two years of easy comps and a surge in the US economy gave SEE a solid 2017. Now, it's back to about half the growth of end markets. To make this even worse, they saw good growth in North America in 2017 and that's about it. Taking pricing costs them volume too:

North Am.	1H18	2017	2016	2015
Volume	0.3%	7.2%	3.0%	0.7%
Price	3.8%	0.6%	-3.8%	0.9%

EMEA	1H18	2017	2016	2015
Volume	2.4%	1.3%	2.0%	2.0%
Price	1.5%	0.8%	0.0%	1.2%

Latin Am.	1H18	2017	2016	2015
Volume	9.2%	1.5%	-6.4%	-6.3%
Price	3.9%	1.0%	17.1%	12.6%

Asia/Pac	1H18	2017	2016	2015
Volume	2.1%	1.4%	-2.6%	1.4%
Price	-0.3%	-0.2%	-0.4%	1.0%

We'll discuss Latin America more later in this report, but inflation and crumbling economies skewed those results with inflationary pricing and negative volume in 2015-16.

So, in our view, SEE should be enjoying stronger results than this given the tailwinds it is enjoying. It reached full potential in 2017 after two easy comps. Moreover, even to generate the results it is doing, it is averaging about a 5% rebate on sales to entice customers. From the 10-K:

> *"Charges for rebates and other allowances were approximately 5% of gross sales in 2017, approximately 5% of gross sales in 2016 and 4% of gross sales in 2015. We expect 2018 rebates and other allowances to be approximately the same percentage of gross sales as in 2017."*

Those rebates are driving sales and coming out of pricing. In the 2Q18, they are seeing raw material cost inflation and are pushing price hikes.

The SEC and IRS Are Both Looking at SEE

In the latest 10-Q, Sealed Air disclosed the following:

> *"On June 25, 2018, the Company received from the staff of the SEC a subpoena for documents, including requests concerning the Company's accounting for income taxes, its financial reporting and disclosures and other matters. The Company is*

cooperating with the SEC in this matter. The Company cannot predict the outcome or the duration of the SEC investigation."

It gave no other details in the 10-Q or the 2Q18 earnings call. This could be a material item or not and there is no timing for when it may end. There is an IRS issue regarding the payment it made in 2014 of $1.49 billion to settle asbestos and other claims related to SEE's acquisition of Cryovac in 1998 from W.R. Grace. Grace later filed bankruptcy over asbestos claims and as a survivor, SEE started to be sued for asbestos as well as fraudulent conveyance over the Cryovac deal.

A deal was finally reached to resolve the asbestos claims and SEE paid $930 million in cash and 18 million shares into the asbestos trusts set up by Grace. The total consideration paid was $1.49 billion. SEE recorded this payment as an expense deduction to income taxes. The IRS has been inclined to disallow 100% of this deduction for some time now:

"We are currently under examination by the IRS with respect to the deduction of the approximately $1.49 billion for the 2014 taxable year for the payments made pursuant to the Settlement agreement. ***The IRS has indicated that it intends to disallow this deduction in full****. We strongly disagree with the IRS position and are protesting this finding with the IRS. The resolution of the IRS's challenge could take several years and the outcome cannot be predicted. Nevertheless, we believe that we have meritorious defenses for the deduction of the payments made pursuant to the Settlement agreement.* ***If the IRS's disallowance of the deduction were sustained, in whole or in part, we would have to remit all or a portion of the refund of taxes previously received and such disallowance could have a material adverse effect on our consolidated financial condition and results of operations****."*

Given that the corporate tax rate was 35% during the years that settlement covered, this could be over $500 million at stake for SEE. There are other tax issues at SEE:

"The Internal Revenue Service (the "Service") has concluded its examination of the legacy Sealed Air U.S. federal income tax returns for all years through 2008, except 2007 which remains open to the extent of a capital loss carryback. ***The Service is currently auditing 2011 U.S. federal income tax returns of legacy Sealed Air. We are also under examination by the IRS for the years 2012-2014. The outcome of the negotiations for this exam period may affect the utilization of certain tax attributes and require us to make a significant payment.***

State income tax returns are generally subject to examination for a period of 3 to 5 years after their filing date. We have various state income tax returns in the process of examination, and are open to examination for periods after 2002.

Our foreign income tax returns are under examination in various jurisdictions in which we conduct business. Income tax returns in foreign jurisdictions have statutes of limitations generally ranging from 3 to 5 years after their filing date and except where still under examination. ***Of the unrecognized tax benefit amount of $214.3 million, $204.7 million relates to North America, most of which is either being disputed or litigated.*** *We have largely concluded all other income tax matters for years prior to 2008.*

Management believes that an adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company's tax audits are resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs."

When we see foreign tax returns and tax benefits are in dispute over North America issues, we think transaction splitting may be the issue the SEC is looking at. Transaction splitting simply involves situations where a company makes a product and ships it overseas and has to allocate the revenue and expenses of the transaction across multiple jurisdictions. What authorities look to discourage is a situation where the bulk of the revenue is recorded in the low-tax area and the bulk of the costs are recorded in the high-tax area. That maximizes income by reducing taxes.

The SEC should be more concerned with disclosure about potential material changes in payments and perhaps reserve accounts that offset deferred tax benefits or boost tax liabilities. The new part of the disclosure in the most recent 10-K concerned the $204.7 million of the $214.3 million unrecognized tax benefit for foreign taxes. That may be what the SEC is looking at. That may require more disclosure or a change in reported income. And with the IRS, there are several hundred million dollars of income in dispute.

The outcomes and timing are difficult to predict given the current disclosure, but investors should be aware that these issues exist.

The Debt Level is High and All the Cash Flow May Not Be Available

On the surface, the debt at SEE looks manageable at $3.3 billion. That would be only 3.7x EBITDA on the $900 million forecast listed earlier. However, much of what SEE does occurs overseas, which generates 49% of revenues. The company does not have easy access to all its cash. At the end of June 75% of the $180 million was overseas and at the end of December 54% of the $594 million was overseas.

Moreover, much of the EBITDA is generated overseas too. Of the 94 manufacturing plants, 62 are outside of North America. Plus, within North America, several of the remaining 32 plants are in Mexico and Canada. The problem is all but about $460 million of the debt is in US dollars – the $460 million is in Euros. When the US dollar is stronger, it takes more foreign currency to convert into the same amount of dollars, thus earnings can come under pressure quickly.

$ to buy	23-Aug-18	29-Dec-17	30-Dec-16	31-Dec-15	31-Dec-14
Euro	1.157	1.202	1.055	1.087	1.211
Aust $	0.727	0.781	0.723	0.729	0.818
Can. $	0.766	0.799	0.745	0.722	0.863
Mex Peso	0.053	0.051	0.048	0.058	0.068
Braz Real	0.245	0.302	0.307	0.252	0.376
China Yuan	0.145	0.154	0.144	0.154	0.161
UK Pound	1.353	1.352	1.234	1.476	1.559

It doesn't even need to be Venezuela to create some issues like pre-2016 when SEE eventually closed up operations in the country. The Euro has had two 13% moves in the last 3.5 years. The Australian dollar has moved at least 12%, China 11%, the British Pound 21%.

SEE breaks down sales by region, but not EBITDA or operating profits – those are by division. But it doesn't take much movement in some of these currencies and the inability to move the money to the US to make the debt load more onerous. There are many What-If scenarios but, interest expense is running about $180 million and only $21 million of that is not in US Dollars. Assuming, half the EBITDA comes from the US or $450 million, the remaining $450 million may move by 10% simply from FX movements or $45 million and SEE may only be able to bring back half of that money - that effectively makes EBITDA to service US debt $652 million. Again, this is hypothetical just to illustrate the potential risk, but having cash overseas is a reality here as is FX cutting EBITDA.

	Total Results	US $ Results
EBITDA	$900	652
Interest	$180	$159
Int Cov	5.0x	4.1x
Debt	3335	2875
D/EBITDA	3.7x	4.4x

It is also obvious how much FX makes an impact on results at SEE over the years.

SEE Growth	1H18	2017	2016	2015
Volume change	1.8%	4.5%	1.2%	0.3%
Price change	2.7%	0.2%	-0.4%	2.5%
FX impact on Sales	2.1%	0.7%	-2.9%	-10.3%
FX $ Impact on EBITDA	$7.7	$4.9	-$39.1	-$125.8

While we are not going to forecast the currency markets or even try to time them under any time-frame, we are going to point out that this is an issue that has played a major roll in hurting SEE results only a few years ago. And many currencies move in big enough waves to create a possible negative impact again.

Ed Doheny made several comments about FX becoming a headwind in the rest of 2018 on the 2Q18 call – nothing to the extreme of 2015, but is impacting guidance:

> *"We now forecast currency to have a negative impact on net sales of $20 million. This updated forecast assumes currency headwinds on Food Care results due to exposure to Europe, Latin America, Australia, and New Zealand."*
>
> *"Our outlook for adjusted EBITDA remains the same at $890 million to $910 million, implying a margin of 19%. This outlook now assumes unfavorable currency of negative $5 million as compared to our previous outlook, was in positive currency of $20 million."*

So, currency is moving quickly again and SEE is offsetting some of headwind with acquisitions that were not in place at the start of the year.

There Are Some Significant Devaluations in 2018

Continuing the FX discussion further, SEE may be forced to lower guidance in this area again. Look at the performance year to date in several countries:

$ to buy	23-Aug-18	29-Dec-17	YTD change	% sales
Turkey	0.164	0.264	-38.0%	n/a
Argentina	0.033	0.054	-38.0%	1%
Brazil	0.245	0.302	-19.0%	3%
Russia	0.015	0.017	-16.0%	2%
China	0.145	0.154	-6.0%	n/a

We know they have operations in all these countries. In fact, we noted above that there was a large volume gain in Latin America in 2018 as SEE took market share. That may be due to other companies exiting the market like SEE did in Venezuela.

We do not yet see an official exchange rate vs. black market situation developing in these countries like Venezuela, which caused many companies to see excessive growth rates in South American operations like Newell Brands. Essentially, the black market, which consumers were using to buy items in dollars, was 100 to 1 and Newell was translating results at basically 6 to 1 on the official rate. The result was they could sell something for literally half price – let's call it 50 Bolivar, which was worth 50-cents, but translate the 50 Bolívar at the official 6 to 1 rate and reported sales are over $8.

We also would not expect SEE to benefit as much if a similar situation develops because much of its business is done with other corporations not direct consumers – who else is buying plastic meat trays?

However, there are red flags such as Argentina in the past has restricted outflows of foreign currency and thus companies could not sell their pesos. Convertibility in China has also had controls. From this standpoint, it becomes an issue again for how much of the reported EBITDA and cash flow is actually available to SEE to service debt.

In addition, SEE deals with FX translation for non-inflationary countries by converting financial results at the end of the period. However, for inflationary countries like Argentina – they use an average rate over the period. Obviously, as the currency falls, it takes more of the local currency to buy a dollar. Using the average rate during periods of rapid decline can overstate the reported results. For example, if Argentina has $10 million in sales and

$15 million in assets, and the average over the reporting period is 0.04 or 25 Pesos to the dollar the sales are $400,000 and assets $600,000. But, at the end of the period, the Peso value is really 0.03 or 33 Pesos to the dollar than the sales would fall to 303,000 and assets to $454,550.

Again, we are not trying to forecast changes in currencies vs. the US dollar. We just want to point out some of the risks related to FX changes can have a material impact on SEE results.

Rising Raw Material Costs, Price Hikes are Driving up Working Capital

The balance sheet is also showing increases in working capital accounts such as receivables, inventories and payables. Some of this can be explained with both headwinds in the cost of raw materials. Others are customers asking for more eco-products such as using renewable materials. Some of this is being offset with some price increases as we noted above. However, we would still argue that the rebates and customers wanting to control their own costs are limiting some of the pricing power. SEE anticipates the 2H2018 will be price related for much of the growth over volume. That runs counter to customers' wishes in the long run in our view.

In 2018, working capital has become a drag on cash flow:

Working Capital	1H18	2017
Receivables change	-$56.9	$91.9
PrePaid Change	$120.7	-$20.6
Inventory Change	$73.4	$50.1
Payables Change	$66.9	$184.2
Net impact	$70.3	-$62.8

In 2017, working capital added $62.8 million to cash flow because payables rose so rapidly y/y. In the first half of 2018, this was $133.1 million swing in working capital. Also, it is important to note that the prepaid assets are tied to receivables. SEE has securitization programs in place in the US and Europe. When the European one is used, the receivables pledged are reclassified to prepaid expenses. Thus, the drop-in receivables actually reverses when accounting for the reclassification. We added prepaid assets to A/R to calculate DSOs.

How much further can SEE stretch some of these accounts:

	1H18	2017	2016
DSOs	51.2	47.3	44.0
DPOs	91.9	85.6	69.1
Inv Days	108.7	84.4	74.3

We think this has the potential to further hurt cash flow, as well as margins if customers start to push back on price increases.

Acquisitions and Restructuring

We cannot be too critical in this area. We see so many companies that are buying companies unrelated their businesses and deals that are huge relative to their current size. That's not really the case with SEE, although the acquisitions have picked up. B+ Equipment was bought in 3Q15 but was only a $19 million purchase. Nothing in 2016. Two deals in 2017 – Deltaplam for $26 million and Fagerdala for $107 million. Finally, AFP in August 2018, where terms were not disclosed. It has more sales than Fagerdala. All of these deals add to what SEE already does. The company notes the margins are lower but expects some synergies to emerge. Overall, these aren't that material – but should probably be viewed as capital spending.

So, while Free Cash of over $400 million looks sustainable, there appears to be growing pressure of about $100 million per year for acquisitions and working capital could be another headwind.

In terms for restructuring – we again will not harp too much on SEE because we see companies that have been in perpetual restructuring since the Hoover Administration and each plan grows, until the next one is announced that is even larger. In recent years, SEE has sold a major asset and had a plan to restructure by focusing on its faster growing markets. At the time, the forecast was it would cost $410-$420 million and capital spending would be about $240-$245 million. To date, SEE has spent $378 million and $235 million on capital spending. Another $20 million will be spent in the next 12 months and $3 million in the 2H2019. Margins have improved, and some synergies already realized.

Conclusion:

There are enough growth tailwinds here to justify much of why someone should like this story. There is also enough cash flow to give the company some cushion to get through rough spots if needed.

The potential for $500 million tax bill and an SEC inquiry into tax disclosure appear to be real concerns – but the timing of both issues to be fully resolved is very unclear.

The FX issues have stung them in the past and in some markets appear ready to strike again. It is such a key part of the business, investors may just have to endure some rocky times and occasionally enjoy some tailwind too. FX has been a significant cash squeeze in the past and the inability to access all the cash at SEE because it is overseas is a risk to effectively make the debt a bigger issue.

Inflation that is hurting SEE on FX, also appears to be squeezing them on working capital which in turn is hurting cash flow as well.

Clorox (CLX) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	NA

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

We initiate coverage of Clorox (CLX) with a 4+ (Acceptable) rating.

CLX topped consensus EPS targets by 9 cps in the 6/18 quarter. After a review of the 10-K, we have little in the way of significant concerns with CLX's earnings quality. However, we do observe that results continue to benefit from lower advertising expense which will likely become a headwind in the upcoming quarters.

Advertising Continued to Decline in the Quarter

The trend of lower advertising expenditures continued into the 6/18 quarter, as shown in the following table:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Sales	$1,691	$1,517	$1,416	$1,500
Advertising Expense	$146	$150	$140	$134
% of sales	8.6%	9.9%	9.9%	8.9%

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$1,647	$1,477	$1,406	$1,443
Advertising Expense	$182	$161	$128	$128
% of sales	11.1%	10.9%	9.1%	8.9%

As we pointed out in the previous quarter's review, the 6/18 and 3/18 quarters were easy comparisons due to unusually high advertising spend in the corresponding year-ago periods. However, the sequential decline in advertising expense in the 6/18 quarter does look unusual. Management still expects advertising for 2019 to come in at 10% of sales which will require an increase in the current pace of spending, implying a potentially difficult comparison in the upcoming 9/18 quarter. At the very least, the tailwind experienced in the last 2 quarters will disappear going forward. This is more of a fundamental issue than an earnings quality issue, which is why we chose to rate the company a 4 rather than a 3.

Charles River Laboratories (CRL) EQ Review Update-6/18 Quarter

Current EQ Rating*	Previous EQ Rating
4+	NA

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

We initiate coverage of Charles River Labs (CRL) with a 4+ (Acceptable)

CRL posted EPS of $1.62 in the 6/18 quarter. This was 16 cents ahead of the consensus, but 14 cents were a result of higher gains from venture capital investments.

The bulk of CRL's revenue is derived from the delivery of services under contract which are recognized over time. Therefore, there is a relatively large degree of estimation and management judgement involved in arriving at reported revenues and profits. This requires special attention to determine the reliability of reported results. In short, we do not see anything in the 6/18 results indicating results have been overstated. We briefly discuss the recent trends in key accounts and trends to keep an eye on below.

Review of Revenue Recognition Trends

The majority of CRL's revenue relates to services under contract which are recognized as the work is done. By nature, determining the timing of recognizing revenue on the income statement requires a large degree of estimation and management judgement which leaves open the possibility of distortion in reported results. While we noted in an earlier review that receivables were outrunning sales as deferred revenues were declining, this trend has now reversed itself, making us much more comfortable with recently-reported revenues and profits. The following table shows the trend in client receivables, unbilled receivables and deferred revenues:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Client Receivables	$372.36	$343.55	$335.84	$321.47	$306.24	$301.25	$284.00
Unbilled Receivables	$108.58	$98.80	$96.30	$103.39	$94.52	$84.84	$82.20
Total Receivables	$480.94	$442.35	$432.14	$424.86	$400.75	$386.09	$366.20
Short-Term Deferred Revenue	$130.39	$98.47	$117.57	$108.98	$119.34	$127.59	$127.73
Customer Contract Deposits	$37.54	$23.57	$0	$0	$0	$0	$0
Client Receivable DSOs	58.1	63.5	64.0	63.2	59.6	61.7	55.5
Unbilled Receivables DSOs	16.9	18.3	18.4	20.3	18.4	17.4	16.1
Total Receivable DSOs	75.0	81.7	82.4	83.5	78.0	79.0	71.6
S/T Deferred Revenue Days	20.3	18.2	22.4	21.4	23.2	26.1	25.0
Rec.DSOs less S/T Def. Rev. Days	54.7	63.5	60.0	62.1	54.7	52.9	46.6

In the 6/18 quarter, total receivables (client and unbilled) days of sales (DSOs) declined by 3 days compared to the year-ago period. Meanwhile, short-term deferred revenue days of sales declined, which is ordinarily a concern as it could indicate more aggressive revenue recognition. However, when deferred revenue is recognized, it must first be moved into accounts receivable (if a bill is sent) or unbilled revenue (if a bill is not sent). Therefore, for a complete analysis, one must subtract deferred revenue days from accounts receivable DSOs and track the resulting number. In this case, receivable DSO minus deferred revenue days for the 6/18 quarter was flat versus the year-ago period. Note that is before any adjustment for the receivables added from the 4/3/18 acquisition of MPI Research. We view this as a positive sign for the quality of recently reported revenue.

In addition, the company also recorded substantial customer contract deposits, shown in the table above. These are very similar to deferred revenue in nature, indicating more conservatism in revenue recognition.

We also call to attention that under the new ASC 606 guideline for revenue recognition, CRL has begun to report several new metrics which will be useful in future analysis. One very interesting item is the disclosure of revenue expected to be recognized in the future from current performance obligations in contracts existing at the end of each period. This information is shown in the below table:

Revenue Expected to Be Recognized Under Performance Obligations as of:

	6/30/2018	3/31/2018
Less than 1 year	$715.40	$204.87
1-3 years	$374.95	$310.03
4-5 years	$128.50	$0.00
>5 years	$115.49	$0.00
	$1,334.33	$514.90

This data is not provided on a historical basis, so we cannot analyze the trend prior to the 3/18 quarter. Nevertheless, the strong sequential improvement in the 6/18 quarter seems to bode well for future growth as well as offering no indication of aggressive recognition.

On a final note, we point out that the company has begun to break out its long-term deferred revenue as a separate item in the footnotes. On the balance sheet, short-term deferred revenue has always been reported as its own line item while long-term deferred revenue is lumped into other liabilities, making it impossible to observe trends in the long-term component. (This is why the above table utilizes only short-term deferred revenue.) Long-term deferred revenue for the last three quarter was $11.3 million, $10.3 million and $8.3 million. Given its relatively small size, it is not likely that historical balances materially impacted the above analysis, but this will nonetheless be an important item to monitor going forward.

Home Depot (HD) EQ Review Update- 7/18 Quarter

Current EQ Rating*	Previous EQ Rating
5-	NA

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

We initiate coverage of Home Depot (HD) with a 5- (Strong)

As with our previous review of HD, we see no items in the company's recent 10-Q that warrant concern about the quality of reported results. On a trailing 12-month basis, the company's free cash flow does not cover its dividend and buyback. However, HD's low leverage along with its scaling back of the buyback make this a non-issue.

ResMed (RMD) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	NA

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

We initiate coverage of ResMed (RMD) with a 3- (Minor Concern)

Our review of the company's 6/18 10-K turned up several items investors should be aware of:

- RMD utilizes third-party financing institutions to offer certain customers financing for its products. While not a traditional factoring program, this should be monitored for signs of aggressive credit extension being used to fuel sales growth. The company's disclosures do not indicate this has been a problem in recent quarters.

- The company makes regular, material investments in "research and service" companies which it accounts for under the cost-method. While we are admittedly uncertain as to the nature of these investments, we are somewhat concerned that they could have the effect of capitalizing research and related expenses, thus keeping them off the income statement.

- RMD has received notice that it could have to pay up to $190 million in taxes, interest and penalties to the Australia Tax Authority (ATO) stemming from an audit of 2009-2013 and the ATO now has its sights on 2014-2017.

- The Office of Inspector General (OIG) has issued 3 subpoenas to the company since 2016 which appear to be related to an anti-kickback investigation. We have no indication of the likelihood of a negative outcome, but investors should be aware of the situation.

Third-Party Financing of Receivables

RMD utilizes third-party financing to offer some customers financing of its products. The company provides the following description in its 10-K regarding the program:

> *"We use independent financing institutions to offer some of our customers financing for the purchase of some of our products. Under these arrangements, if the customer qualifies under the financing institutions' credit criteria and finances the transaction, the customers repay the financing institution on a fixed payment plan. For some of these arrangements, the customer's receivable balance is with recourse, either limited or full, whereby we are responsible for repaying the financing company should the customer default. We record a contingent provision, which is estimated based on historical default rates. This is applied to receivables sold with recourse and is recorded in accrued expenses."*

This program is slightly different than a traditional factoring program when a company simply sells receivables to a third-party finance institution in order to collect cash up front as the financial institution appears to be directly involved with the customer in originating the loans. However, the fact that these receivables are sold with recourse indicates that RMD has more "skin in the game" than if the transaction was done entirely between the customer and the bank.

RMD does not disclose what the outstanding balances of receivables held by the bank are at the end of each period, so we can't adjust company receivables as accurately as we can with some companies. However, RMD does disclose the amount of receivables sold during the quarter, so we can get a feel for overall activity. These amounts are shown for the last eight quarters below:

Receivables Sold During the Period

	06/30/2018	03/31/2018	12/31/2017	09/30/2017
Full Recourse	$9.7	$6.2	$5.7	$4.2
Partial Recourse	$23.1	$20.3	$18.5	$17.4
Total	$32.8	$26.6	$24.2	$21.6
% of Sales	5.3%	4.5%	4.0%	4.1%

	06/30/2017	03/31/2017	12/31/2016	09/30/2016
Full Recourse	$10.1	$6.1	$7.0	$1.5
Partial Recourse	$21.8	$19.2	$18.0	$15.8
Total	$31.8	$25.3	$24.9	$17.3
% of Sales	5.7%	4.9%	4.7%	3.7%

We can see that while the level of sales activity as a percentage of sales has risen sequentially, it has actually declined on a year-over-year basis for the last 3 quarters. This does not indicate that sales have been driven by a rapid increase in the use of customer credit.

In addition, RMD discloses its maximum exposure on outstanding receivables at the end of each period which is shown in the below table:

Maximum Exposure on Outstanding Receivables Sold

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Full Recourse	$20.1	$18.3	$18.3	$18.3
Limited Recourse	$9.2	$9.4	$8.9	$11.1
Total	$29.4	$27.7	$27.2	$29.4
% of Sales	4.7%	4.7%	4.5%	5.6%

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Full Recourse	$18.1	na	na	na
Limited Recourse	$9.4	na	na	na
Total	$27.5	$22.6	$16.6	$14.4
% of Sales	4.9%	4.4%	3.1%	3.1%

Like the data on receivables sold during each of the last eight quarters, the company's total exposure to sold receivables also seems to indicate that there has been a significant uptick in financing activity to support sales growth. However, we do observe that the sequential increase in total exposure came from receivables with full recourse. We no not view this as a material item, but we will be monitoring this trend going forward.

Cost-Method Investments

RMD has substantial investments that it accounts for under the cost method. There is little description of these in the company's financial filings other than the following from its 6/18 10-K:

> *"We periodically evaluate the carrying value of our cost-method investments, when events and circumstances indicate that the carrying amount of an asset may not be recovered. We determine the fair value of our cost-method investments to evaluate whether impairment losses shall be recorded using Level 3 inputs.* ***These investments include our holdings in privately held service and research companies that are not exchange traded and therefore not supported with observable market prices.*** *However, these investments are valued by reference to their net asset values which can be market supported and unobservable inputs including future cash flows. We have determined that the fair value of our cost-method investments exceed their carrying values."*

The following table shows the development of the company's cost-method investments balance over the last six quarters:

Cost-Method Investments Balance

	6/30/2018	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Beginning Balance	$41.1	$39.8	$40.6	$38.3	$39.7	$37.5
Investments	$8.1	$2.7	$0.5	$3.2	$0.0	$2.6
Impairment	-$8.0	-$1.4	-$1.3	-$1.0	-$1.4	-$0.4
Ending Balance	$41.2	$41.1	$39.8	$40.6	$38.3	$39.7

Our main concern with these amounts is that these are cash expenditures made to "service and research" companies about which there is little description. If the company is receiving any benefit from research or services conducted by these companies, this could effectively be capitalizing these expenses and keeping them off the income statement. We have not had a chance to speak to the company about this yet but will likely be doing some follow up work on this in the future.

Australian Tax Overhang

The company recently received a notice from the Australian Taxation Office (ATO) asserting that the company owes $151.7 million in additional income tax and $38.4 million in accrued interest related to the ATO's audit of the company's 2009-2013 tax years. RMD is contesting the assessment and agreed to pay half of this amount up front and the remainder if it is unsuccessful in defending its position. In June, it received another notice from the ATO that it is seeking a penalty of 50% of the addition income tax assessed, which is another $76 million. In addition, the ATO notified the company it now intends to audit 2014-2017. We do not have any insight into the company's chances of success in contesting ATO's assertions, nor the possibility of a negative development from the new audit. Nevertheless, the amounts in question are quite material and investors should be aware of the possibility of a materially negative outcome.

OIG Subpoena

RMD noted in its 10-K that it has received three subpoenas from the Office of Inspector General (OIG) since 2016:

> *"Federal and state enforcement bodies have recently increased their scrutiny of interactions between healthcare companies and healthcare providers, which has led to a number of investigations, prosecutions, convictions and settlements in the healthcare industry. For example,* ***in July 2016, we received a federal administrative subpoena from the Office of Inspector General, or OIG, of the Department of Health and Human Services. The subpoena contains a request for documents and other materials that relate primarily to industry offerings of patient resupply software to home medical equipment providers. In November 2016, we received a second subpoena, requesting documents and other materials regarding discounted sales and leasing to sleep labs, samples, and other promotional programs. In August 2018, we received a third subpoena requesting documents and other materials relating to diagnostic devices and masks provided to medical providers and diagnostic auto-scoring functions. In addition, the government has informally requested information about our leasing arrangements with customers****. We are cooperating with the government's subpoenas and request s for documents and information. Responding to investigations can be time-and resource-consuming and can divert management's attention from the business. Additionally, as a result of these investigations,*

healthcare providers and entities may face litigation or have to agree to settlements that can include monetary penalties and onerous compliance and reporting requirements as part of a consent decree or corporate integrity agreement. Any such investigation or settlement could increase our costs or otherwise have an adverse effect on our business."

This appears to be related to anti-kickback rules that do not allow medical supply companies to offer free or discounted products or services to medical care providers in exchange for them buying their products. We note that one of the company's competitors, Philips Respironics, lost a $34 million lawsuit in 2016 for providing free customer support though its call centers for suppliers who bought its products. We do not know if the OIG investigation is of a related matter and we do not have any reason to expect a negative outcome, let alone the potential size of any fines. We simply believe this is a matter that investors should be aware of.

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 recent 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 Concerns"	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 may 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 the next quarter. 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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