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BTN Research

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Facebook (FB) EQ Review- 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 Facebook (FB) with a 4- (Acceptable)

FB reported EPS of $1.74 in the 2Q18, which beat forecasts by 3-cents. This was a considerably less than strong beat for a company that routinely has beaten forecasts by 10-36 cents per quarter for years. There are actually very few material issues in the basic accounting that concern us. The company doesn't have inventory, uses relatively quick depreciation/amortization lives, and receivables are not changing in a material way compared to sales. Compared to other FANG stocks, FB has strong free cash flow, essentially zero debt, huge cash reserves and has not been diluting shareholders.

Only three wildcards give much concern – tax assumptions, operating costs/capital spending rising faster than revenues and potentially squeezing margin, and foreign exchange.

- **Working capital trends are not problematic at FB.** The company is very liquid with large cash and securities balances and it is not only self-funding, free cash exceeds net income frequently.

- **Receivables are the only material working capital account and DSOs have been very flat.**

- **Discretionary costs are more likely to be a headwind.** FB enjoyed economies of scale in 2006 and 2007 as R&D and marketing costs as a percentage of sales declined, which fueled some huge earnings beats. The company is ramping up spending again and FB should see some margin pressure.

- **Capital spending is also rising rapidly which should cause depreciation to rise too.** Investing in the business and adding more safety and privacy features should be good in the long run, but the expenses may rise faster than revenues in the near-term.

- **A stronger dollar hurts FX translations.** With much of the assets and employees in the US and 58% of revenues from foreign countries, FB's revenue can move more with FX than costs. Historically this is a headwind, but is much larger in 2018 than 2017.

- **Taxes have several issues such as a higher stock price lowers the tax rate via stock-compensation becoming exercisable and vice versa along with transfer pricing or transaction splitting whereby FB allocates the revenue and costs of each transaction between the US and many foreign jurisdictions.** Both situations may be changed due to a court case and examination by taxing authorities.

- **Depreciation lives have increased about half-**a-year by our estimates and this has given FB a few cents in additional EPS. Amortization is falling as the assets are expensed rapidly and should continue to be a tailwind as well barring a new acquisition.

Working Capital Trends are Not Problematic

What is quickly obvious is Facebook is very liquid. Most of the current assets are cash and securities and even prepaid and other current assets include restricted cash-like deposits. There is no inventory and almost no payables. Accrued expenses consist of wages payable, purchase commitments, and tax benefits tied to foreign transaction splitting – more on this later.

	2Q18	1Q18	4Q17	3Q17
Cash	$11,552	$12,082	$8,079	$7,201
Mrk. Securities	$30,757	$31,874	$33,632	$31,088
Accts Receivable	$5,590	$5,115	$5,832	$4,424
Prepaid & Other	$1,934	$1,341	$1,020	$1,490
Current Assets	$49,833	$50,412	$48,563	$44,203
Accts Payable	$419	$593	$380	$383
Partners Payable	$440	$396	$390	$314
Accrued Exp & Other	$3,720	$4,003	$2,892	$2,503
Deferred Revenue	$91	$94	$98	$105
Current Liabilities	$4,670	$5,086	$3,760	$3,305

Marketable securities are mostly in US and US agency debt, so we do not see an issue there. Total cash and securities ($42 billion) exceed total debt ($11 billion which includes $0 in borrowed debt) by nearly 4x. Moreover, FB does not have many of the problems of other FANG stocks. It is free cash flow positive – in fact, free cash flow often exceeds net income, so the company is not consistently raising capital. FB does not use capital leases, which effectively raises cash from operations and free cash flow because only the interest expense of the lease payment impacts those areas. It is self-funding and is even avoiding dilution from share-based compensation:

	2Q18	1Q18	4Q17	3Q17
Net Income	$5,106	$4,988	$4,268	$4,707
Cash Ops	$6,299	$7,860	$7,670	$6,128
Capital Exp	$3,459	$2,812	$2,262	$1,755
Acquisitions	$16	$49	$17	$98
Free Cash Flow	$2,824	$4,999	$5,391	$4,275
Share Count	2,930	2,945	2,954	2,956

The only non-cash material working capital account is Accounts Receivable. We are not seeing any trends that cause alarm here:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Sales	$13,231	$11,966	$12,972	$10,328
Accounts Receivable	$5,590	$5,115	$5,832	$4,424
Sales YOY growth	41.9%	49.0%	47.3%	47.3%
Accounts Receivable YOY growth	43.4%	49.8%	46.1%	44.1%
Sales Seq growth	10.6%	-7.8%	25.6%	10.8%
Accounts Receivable Seq growth	9.3%	-12.3%	31.8%	13.5%
Accounts Receivable DSOs	**38.6**	**39.0**	**41.0**	**39.1**

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$9,321	$8,032	$8,809	$7,011
Accounts Receivable	$3,897	$3,415	$3,993	$3,070
Sales YOY growth	44.8%	49.2%	50.8%	55.8%
Accounts Receivable YOY growth	39.1%	45.4%	56.0%	52.7%
Sales Seq growth	16.0%	-8.8%	25.6%	8.9%
Accounts Receivable Seq growth	14.1%	-14.5%	30.1%	9.6%
Accounts Receivable DSOs	**38.2**	**38.8**	**41.4**	**40.0**

Discretionary Costs Should Be Margin Headwinds – FB Investing More

Many companies we review for earnings quality pick up 2-3 cents of EPS by cutting discretionary costs like R&D, marketing, or bad debt expense. We point these out because often these reductions are short-term and likely to bounce back and deny the company this source of earnings. FB is actually doing the reverse of this situation and has started to rapidly boost spending in these areas in dollar terms and as a percentage of sales:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Sales	$13,231	$11,966	$12,972	$10,328
Research & Development	$2,523	$2,238	$1,949	$2,052
R&D % Sales	19.1%	18.7%	15.0%	19.9%
Marketing Expense	$1,855	$1,595	$1,374	$1,170
Marketing % Sales	14.0%	13.3%	10.6%	10.7%
Stock Comp % Sales	9.0%	8.0%	6.3%	9.8%
Capital Spending	$3,460	$2,812	$2,262	$1,755
CapX % Net PP&E	18.8%	17.3%	16.5%	14.4%

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$9,321	$8,032	$8,809	$7,011
Research & Development	$1,919	$1,834	$1,563	$1,542
R&D % Sales	20.6%	22.8%	17.7%	22.0%
Marketing Expense	$1,124	$1,057	$1,118	$926
Marketing % Sales	12.1%	13.2%	12.7%	13.2%
Stock Comp % Sales	11.1%	10.8%	9.4%	11.8%
Capital Spending	$1,498	$1,217	$1,269	$1,085
CapX % Net PP&E	**14.1%**	**12.9%**	**14.8%**	**13.7%**

The company had the perfect tailwind of gaining margin points from R&D, Marketing, and overall stock compensation (which also impacts COGS and G&A expense) in late 2017 both sequentially and year-over-year. This generated considerable earnings growth. 100bp of margin gain in 4Q17 was worth 4-cents per share and in just R&D and marketing, FB gained 480bp y/y or about 19-cents and the company beat forecasts by 26 cents.

As a tech company, FB does have to reinvent itself and those types of costs should be expected to rise. In fact, we would not be surprised if these costs continue to increase regardless of fluctuations in revenue growth and the normal seasonality in revenue that FB experiences. We think overall, this is a good thing for FB – R&D and Marketing should have a useful life for many quarters if not years. But, it looks to us as though investors should view 2017 as an aberration for margin gains and some headwind here is a more likely outcome.

	1H18	2017	2016	2015	2014
R&D % Sales	18.9%	19.1%	21.4%	26.9%	21.4%
Marketing % Sales	13.7%	11.6%	13.6%	15.2%	13.5%

The longer-term view shows this same issue. Obviously, the company was smaller in 2014 and 2015, but it has always actively invested in its business. There have been spikes in

spending like in 2015 and then some economies of scale in 2016 and 2017. But, it appears that investors should not be expecting a long-term situation of margin gains from having revenues grow faster than discretionary items. Some of the increases in costs are also coming from adding more security and privacy controls to the websites, which may be a selling point to customers, but doesn't directly add to revenues. That would cost FB some margin.

We also want to focus on the huge surge in capital spending. FB is spending heavily on data centers, network infrastructure, offices, and servers. Net PP&E has nearly doubled in the last year. Capital spending is expected to come in around $15 billion in 2018 versus $6.7 billion in 2017. Again, investing in the company and its assets is not a bad thing. But, 90% of fixed assets at FB are network equipment, which should have a short life, and buildings. The average life for assets at FB is about 5 years. So, this is another headwind that should impact earnings.

Depreciation has normally been about 7.5%-8.5% of sales. It was down to 6.6% in 4Q17 and is now back at 7.8%-7.9% in 2018 with the heavy spending. This again points to 4Q17 being an aberration in our view that enjoyed another 40-50bp of margin gain. We expect depreciation to become a headwind also.

Foreign Exchange Is a Wild Card

A large part of FB's revenue comes from outside the US. However, most of its fixed assets and wages are in the US. This helps income from outside the US become larger.

	1H18	2017	2016	2015
Rev % US	42%	44%	46%	47%
Rev % Non-US	58%	56%	54%	53%

	1H18	2017	2016	2015
PP&E in US	76%	76%	79%	79%
PP&E Non-US	24%	24%	21%	21%

	2017	2016	2015
Income % US	34%	51%	45%
Income % Non-US	66%	49%	55%

As a result, costs are more likely to be in US dollars and revenues in another currency. Generally, when the US dollar is strong, the translation of FX results in pressure on revenue while a weak US dollar helps reported revenue. FB uses an average rate over the period to translate revenues and expenses. This policy is fine in our view except for currencies seeing extreme devaluation such as Venezuela or Turkey. However, with exposure to nearly every country in the world, we do not have a problem with the translation policy.

FB nets interest income, interest expense and FX gains/losses under Other Income. It generally loses money on FX exchange, but the amount can vary. We noted in the Sealed Air report last week how many currencies had declined vs. the US dollar in 2018. This looks like another area where FB had a great year in 2017 followed by a headwind in 2018. FX is basically a 4-cent reduction in EPS for 1H18.

	1H18	2017	2016	2015
FX losses	$123	$6	$76	$66

Some of this is due to translating revenues back. However, while smaller than the US, there are still billions of dollars of FB assets overseas. At the end of June 2018, there was $4.4 billion in net PP&E and $14.0 billion of cash and securities overseas. Those assets are also getting converted at period end to US Dollars and a stronger dollar should reduce those values.

The bigger issue with all the foreign exposure is taxes in our view.

Taxes Have a Much Larger Variance at FB than other Costs

A great deal happened in 2017 with the new Tax Act lowering the US tax rate from 35% to 21%. As part of this rule, FB recognized a one-time transition tax provision of $2.27 billion against accumulated foreign subsidiary income. This boosted the effective tax rate by 11-percentage points. The company also had greater share-based compensation tax benefits that lowered the effective rate by 6-percentage points. Lower tax rates in the US and a higher percentage of income in lower-tax foreign places helped lower the effective rate too. The result is a tax rate that varies quite a bit and is expected to see that again in 2018

	2018e	3q18e	2q18	1q18	2017	2016	2015
tax rate	15%-16%	23%	13%	12%	23%	18%	40%

When the stock price is rising, FB should have more stock issued as compensation vested and exercisable over the strike price. It recognizes a tax benefit during these times. So, a rising stock price gives the company more tax relief and a falling stock price effectively boosts their tax rate. In 2017, this shield cut the tax rate by 6-percentage points ($1.25 billion) and in 2016 it was 7-percentage points ($934 million.) Thinking of it in EPS terms, this was 42-cents of EPS in 2007.

It appears that with the stock price down after 2Q results, this will become more of a headwind for the rest of 2018. The company has guided to that. Also, the share-based tax shield may be falling further with a new court ruling.

> *"On July 24, 2018, the Ninth Circuit Court of Appeals issued an opinion in Altera Corp. v. Commissioner requiring related parties in an intercompany cost- sharing arrangement to share expenses related to share-based compensation. This opinion reversed the prior decision of the United States Tax Court. We are evaluating the opinion as it applies to our facts and circumstances and we currently expect it will increase our effective tax rate for the third quarter."*

FB noted in the 2Q call that it expects to record a one-time charge for this and that is why they expect at 23% tax rate for 3Q18. It remains to be seen if this will reduce future tax benefits.

The other big concern is transaction-splitting assumptions. Facebook has a considerable amount of revenue coming from overseas often in lower tax areas while at the same time much of the expense is in the US which may still have a higher tax rate some of the countries overseas. They have to allocate each deal in terms of revenue and expense by geography to arrive at income to pay taxes in each jurisdiction. Naturally, most governments want to maximize income in their jurisdictions and will look at things such as how FB makes its assumptions. When FB reports 76% of its assets and 42% of revenue are in the US, but only 34% of income, that creates a risk in our view for the IRS to examine and it appears that risk is already a potential as investigations are ongoing. From the FB 10-Q:

> *"We are subject to taxation in the United States and various other state and foreign jurisdictions. The material jurisdictions in which we are subject to potential*

> *examination include the United States and Ireland.* ***<u>We are under examination by the Internal Revenue Service (IRS) for our 2014 through 2016 tax years and by the Ireland tax authorities for our 2012 through 2015 tax years. Our 2017 tax year remains open to examination by the IRS. Our 2016 and subsequent tax years remain open to examination in Ireland."</u>***
>
> ***<u>"In July 2016, we received a Statutory Notice of Deficiency (Notice) from the IRS related to transfer pricing with our foreign subsidiaries in conjunction with the examination of the 2010 tax year. While the Notice applies only to the 2010 tax year, the IRS states that it will also apply its position for tax years subsequent to 2010, which, if the IRS prevails in its position, could result in an additional federal tax liability of an estimated, aggregate amount of up to approximately $5.0 billion in excess of the amounts in our originally filed U.S. return, plus interest and any penalties asserted</u>***. *We do not agree with the position of the IRS and have filed a petition in the United States Tax Court challenging the Notice. As of June 30, 2018 , we have not resolved this matter, and proceedings continue in the United States Tax Court.* ***<u>In March 2018, we received a second Notice from the IRS in conjunction with the examination of our 2011 through 2013 tax years. The IRS applied its position from the 2010 tax year to each of these years and also proposed new adjustments related to other transfer pricing with our foreign subsidiaries and certain tax credits that we claimed.</u>*** *If the IRS prevails in its position for these new adjustments, this could result in an additional federal tax liability of up to approximately $680 million in excess of the amounts in our originally filed U.S. return, plus interest and any penalties asserted. We do not agree with the positions of the IRS in the second Notice and have filed a petition in the United States Tax Court challenging the second Notice."*

This has the potential to be a multi-billion-dollar issue for FB. The company has plenty of cash on hand, and it added $2.75 billion to its other liabilities account in 2017 to deal with tax uncertainties. That has been increased to $2.79 billion at the end of June 2018. There is still a risk in our view of seeing less tax shield from changes to share-based compensation tax accounting and the potential to see income from the US become a larger percentage of pretax income and push up the tax rates.

Depreciation and Amortization Average Lives Appear to Be Rising

In recent years, the depreciation schedule for assets has increased asset lives, which should lower depreciation expense:

Years	2017	2016	2015
Networking Equipment	3-20	3-25	3-5
Buildings	3-30	3-30	3-30
Software, Office Eq, Other	2-5	2-5	3-5

We believe this is helping earnings slightly. We looked at the average gross PP&E that is depreciated. Thus, we excluded land and construction in progress at year-end. We compared the adjusted average gross PP&E to reported depreciation expense:

Years	2017	2016	2015
Adj Gross Avg. PP&E	$11.88	$7.91	$5.75
Depreciation	$2.33	$1.59	$1.22
Avg Asset Life	5.1 yrs	5.0 yrs	4.7 yrs

% adj Gross PP&E	2017	2016	2015
Buildings	34%	34%	34%
Network Equipment	55%	56%	55%

Essentially 90% of the assets being depreciated are buildings and network equipment. The building depreciation schedule didn't change in recent years and the percentage of assets in that area didn't change either. It looks like depreciation is not rising as fast as expected because networking equipment is being expensed over a longer period of time. It's still at the low-end of the estimated life range so that mitigates the concern. However, had 2017 still been working on a 4.7 average asset life instead of 5.1 years, depreciation would have been $200 million higher. That would have cost FB about 5-cents in EPS for the full year. When it's beating by 10-30 cents per quarter, that's not a big deal. When it's beating by 3-5-cents, it becomes more meaningful.

Amortization of Intangibles does not appear to be a concern. With acquisitions, FB books assets of acquired users, technology, and patents. The level of acquisitions has been small in recent years. The remaining estimated useful life in years has been declining as expected:

Remaining life	% gross Intangibles	2017	2016	2015
Acq. Users	45%	3.8 yrs	4.8 yrs	5.7 yrs
Acq. Tech	21%	1.8 yrs	2.4 yrs	3.3 yrs
Acq. Patents	17%	5.1 yrs	5.0 yrs	4.7 yrs
Trade Names	14%	2.2 yrs	3.2 yrs	4.1 yrs
Other	4%	2.7 yrs	3.3 yrs	3.5 yrs

Total amortization dropped from $751 million to $692 million in 2017 vs. 2016. Gross intangibles are only $4.6 billion so these accounts are being expensed rapidly. Most of them are seeing the remaining life drop by about 1-year each year so we are not concerned with this. If FB makes a meaningful acquisition, this expense will rise, otherwise, it should continue to fall. A $50 million drop is about 2-cents in EPS. At the current run rate, this expense will be nearly gone in 3-years. Only $1.5 billion net is on the balance sheet.

Goodwill is over $18 billion due to large acquisitions several years ago. As noted in the first section, income and cash flow remain strong so we're not overly concerned of an immediate risk for a write-down in goodwill. It is always possible given rapid obsolescence in tech companies, but FB is accelerating its investment in the company via capital spending, R&D, and marketing. The risk here in our view would simply be the size of a write-down if one occurred given how large this balance is.

Conclusion:

It appears to us that 2017 was almost a perfect period for FB in that margins were rising by having discretionary costs increase more slowly than revenues, longer depreciation lives added to income, and FX was almost a non-event. We would view that as an aberration. History shows that FX is normally a headwind to EPS. The increased investment in Capital Spending, R&D, and marketing are probably a headwind for several more quarters but, may be a positive for EPS in the long term. Amortization is likely to erode more and will be a tailwind to EPS.

The biggest concern from an accounting perspective is taxes. The tax shield from stock compensation may fall due to the lower stock price and the recent court decision may also remove some of those benefits. Audits in the transaction splitting between foreign revenue and US expenses also have the potential to materially raise the income tax rate at FB.

Mohawk Industries (MHK) EQ Review- 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 Mohawk Industries (MHK) with a 3- (Minor Concern) rating.

MHK had a disastrous second quarter, missing EPS targets by $0.39 per share. The stock, which has gradually declined all year, still fell over 15% on the news. Nevertheless, our review of the company's result turned up several apparent one-time benefits in the most recent quarter that seem unlikely to repeat. We remind clients that our rating does not constitute a sell recommendation. MHK sells for about 10 times EBITDA, has very manageable debt, strong free cash flow and should enjoy a macro tailwind from strong housing activity. Regardless, it appears to us that core second quarter results were even weaker than they appeared on the surface and there are several trends that should be monitored going into the next quarter.

- Bad debt reserve fell as a percentage of gross receivables. If the allowance percentage had remained even with the 3/18 quarter, we estimate it would have shaved over 15 cents per share off EPS in the 6/18 quarter.

- A sequential decline in the warranty reserve as a percentage of sales appeared to add another 4 cents to the quarter.

- Rising inventory levels have been a problem all year. While the year-over-year increase in days sales of inventory (DSI) moderated in the quarter, the company's use of FIFO accounting coupled with its relatively slow inventory turns mean that costs from later purchases of higher cost materials and the impact of decreased productivity could be a drain on profits well into the current quarter.

Background on the Quarter

MHK's second quarter was a huge disappointment for investors as several negative trends came hit to cause the earnings shortfall. Management gave this summary of the problems in the conference call:

> *"In the second quarter, we had a stronger dollar and a delay of Godfrey Hirst [pending acquisition] closing, which impacted results by $0.10 a share. The results were also impacted by lower sales than we anticipated, input inflation, transportation costs, lower LVT supply and a tight labor market, which increased our costs. In addition, we had a lower product mix than we anticipated and we reduced our production volumes more than we had thought to begin with. We also had the timing of the price increases were later than we had anticipated."*

Bad Debt Allowance Down

The following table shows the company's allowance for bad debts as a percentage of customer trade receivables for the last 8 quarters:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Customer Trade Receivables	$1,716.75	$1,674.52	$1,538.35	$1,660.99
Allowance for Bad Debt	$78.14	$90.88	$86.10	$91.25
Allowance %	4.6%	5.4%	5.6%	5.5%

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Customer Trade Receivables	$1,651.77	$1,508.93	$1,386.31	$1,523.93
Allowance for Bad Debt	$91.47	$81.24	$78.34	$84.01
Allowance %	5.5%	5.4%	5.7%	5.5%

We can see the significant sequential and year-over-year drop off's both on an absolute basis and as a percentage of gross receivables. We did not see the decline in allowances discussed in either the conference call or the 10-Q, nor do we see how this measure would be impacted by any of the negative events in the quarter such as materials inflation or delayed price increases. MHK does not break out the development of the bad debt reserve account, so we do not know how much was actually expensed in the above periods. **However, for the allowance percentage to have remained even with the 3/18 quarter, it would have taken an additional expense of about $12 million or over 15 cents per share.**

We observe that the company reports an "other receivables" amount in its receivables disclosure. At this point, we are uncertain as to the nature of this account, but we show it below for reference:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Other Receivables	$91.37	$96.87	$96.08	$80.65

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Other Receivables	$69.18	$64.03	$59.56	$54.41

The account balance has been on the rise for the last 8 quarters with a noticeable jump in the 12/17 period. We will be following up with more on this account in a later note.

Warranty Reserve Declined

MHK offers warranties on certain of its flooring products and discloses the warranty reserve balance under the breakdown of its "accounts payable and accrued expenses" account. This amount is shown in the below table as a percentage of sales for the last 8 quarters:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Sales	$2,577.01	$2,412.20	$2,369.10	$2,448.51
Warranty Reserve	$38.97	$40.46	$39.04	$44.20
Allowance % of Sales	1.5%	1.7%	1.6%	1.8%

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Sales	$2,453.04	$2,220.65	$2,182.57	$2,294.14
Warranty Reserve	$45.08	$46.56	$46.35	$37.51
Allowance % of Sales	1.8%	2.1%	2.1%	1.6%

The reserve balance displays a noticeable year-over-year decline starting in the 12/17 period. While the company does not disclose the warranty provision expense for each period, **if we simply assume that the allowance percentage had remained constant as a percentage of sales with the 3/18 quarter, it would have taken over 4 cents per share off of EPS in the 6/18 quarter.**

Inventory Balances Coming Back in Line

MHK's inventories have been outstripping sales and cost of sales growth for the last several quarters resulting in large year-over-year jumps in inventory days of sales in the 9/17, 12/17 and 3/18 quarters.

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Inventory	$2,061.20	$2,044.96	$1,948.66	$1,911.03
COGS	$1,810.46	$1,707.51	$1,615.47	$1,665.21
DSI	103.9	109.3	110.1	104.7

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Inventory	$1,865.94	$1,740.88	$1,675.75	$1,673.24
COGS	$1,673.90	$1,540.29	$1,491.57	$1,567.58
DSI	101.7	103.1	102.5	97.4

The company admitted that it came into 2018 with higher inventory than it wanted to have, and it has been trying to work the balance down. This has involved selling off impaired inventory and reducing production levels which has negatively impacted productivity. In addition, rising costs have been pushing inventories up as well. Consider the following management comment from the second quarter conference call:

> *"In the second quarter, volumes did not increase as we anticipated and we produced less than we sold to reduce inventory. Our productivity declined as we manufactured new products that had higher production costs. These issues have been addressed, but some costs will flow through to our inventory. Our U.S. LVT sales in the period grew less than we forecast due to a delay in shipments of our sourced products. We anticipate a significant increase in LVT sales as our new U.S. production ramps up and the supply of sourced products increases in the third period."*

In short, the problems with inventory are well-known at this point, and management has been dealing with the issue. However, investors should keep in mind that the company turns its inventories relatively slowly and utilizes the FIFO method of inventory accounting. This means the impact of higher costs associated with more recent raw materials prices and lower productivity will be impacting the income statement well into the next quarter.

Sysco (SYY) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
2+	NA

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

We initiate coverage of Sysco (SYY) with a 2+ (Weak)

SYY reported adjusted EPS of $0.94 per share in the 6/18 quarter, a penny ahead of the consensus. However, our review of the company's recent 10-K filings turned up several one-time benefits to recent results that will be disappearing in future quarters. While no one item is overly concerning, the volume of unusual benefits and the fact that virtually all will be expiring going forward prompts our 2+ (Weak) rating.

In addition, we note that we recognize that the company is enjoying a macro tailwind from the stronger economy resulting in people eating out more frequently. We would remind clients that the EQ Review Rating is a reflection of the quality of reported results and does not take into account other factors such as valuation or positive macro trends.

- SYY reversed previous bad debt allowances back into earnings in the 6/18 quarter as provision expense was actually a $10.9 million benefit in the period compared to a $1.4 million expense a year ago. We estimate this added about 1.6 cents per share to EPS in the period and more than accounted for the penny beat in the quarter.

- The company changed how it accounts for stock options in the 9/17 quarter which resulted in benefits to reported earnings of almost 1.5-3.0 cents per share over the last four quarters. That benefit will be gone in future quarters.

- Adjusted EPS has benefitted by over 2 cents per share in each of the last four quarters due to accelerated depreciation expense recorded in the year-ago periods which was not taken out of adjusted earnings per share amounts.

- Self-insurance expense fell by $62 million or about 8.5 cents per share for the fiscal year ended 6/18 due to changes in estimates for reserves. This accounted for over 12% of the reported growth in adjusted EPS for the year.

Provision Expense Benefitted from Reversal of Reserves

The following table shows the company's allowance for bad debts as a percentage of gross receivables as well as the provision expense for the last eight quarters:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Gross Receivables	$4,099.5	$4,293.4	$4,006.2	$4,374.9
Bad Debt Allowance	$25.8	$65.6	$52.6	$41.2
Allowance %	0.6%	1.5%	1.3%	0.9%
Provision Expense	**-$10.9**	$12.2	$11.2	$9.0

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Gross Receivables	$4,043.5	$4,338.6	$4,012.1	$4,232.7
Bad Debt Allowance	$31.1	$56.5	$48.6	$41.2
Allowance %	0.8%	1.3%	1.2%	1.0%
Provision Expense	$1.4	$11.3	$4.4	$3.5

SYY's bad debt allowance rose for the three quarters ending 3/18. However, instead of reporting a provision expense in the 6/18 quarter, SYY recorded a net *benefit* of $10.9 million, effectively reversing a portion of the allowance into earnings. The $12.3 million year-over-year swing in expense added about 1.6 cents per share to EPS in the quarter, more than accounting for the reported 1 cps positive earnings surprise. As mentioned previously, we appreciate that people are eating out again and the company's customers are doing well and able to pay their bills on time. Regardless, the size of the reversal and benefit to the 6/18 quarter is unusual and obviously cannot continue to benefit results to the degree it did in the most recent quarter.

Options Accounting Change Tailwind Ending

SYY adopted FASB ASU 2016-09 (relating to the accounting of share-based payments) in the 9/17 quarter. Below is the company's description of the impact of the adoption from its most recent 10-K:

"Further, the company adopted the provisions that have changed its accounting for excess tax benefits or detriments. ***Excess tax benefits or detriments were previously included within additional paid-in capital in the consolidated balance sheet and were a part of the diluted share calculation. On a prospective basis, excess tax benefits or detriments are included within income tax expense in the consolidated results of operations and are no longer a part of the diluted share calculation. Prior periods have not been adjusted.*** *In fiscal 2018, the company recognized excess tax benefits of $52.1 million from stock option exercises and restricted stock unit vestings that occurred during the period."*

In short, excess tax benefits related to options awards are now reported as a reduction of tax expense, whereas they were previously recorded directly to paid-in capital. **The company specifically quantified this benefit as 3 cents per share in each of the 9/17, 12/17 and 3 /18 quarter 10-Qs. For the fourth quarter, we estimate the benefit fell to about 1.5 cents per share. With the accounting change now anniversaried, this material benefit will be gone in upcoming quarters.**

Depreciation Expense Benefit Will Be Gone Going Forward

SYY has been reporting significantly lower depreciation and amortization expense on a year-over-year basis for the last several quarters. This has been due to accelerated depreciation relating to the shortening of estimated useful lives for an enterprise resource planning (ERP) software system which the company decided to discontinue in 2016. The system was fully depreciated in the 6/2017 quarter. SYY has been adding a portion of this accelerated depreciation back to profits in its adjusted EPS numbers to provide better comparisons. However, all of the accelerated depreciation has not been added back in historical periods, which has been a material boost to EPS growth in the last four quarters, as seen in the following table:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017	7/01/2017	4/01/2017
Depreciation and Amortization	$201.8	$193.4	$190.7	$179.7	$234.7	$218.3
Net PPE	$4,521.7	$4,392.2	$4,366.3	$4,388.3	$4,377.3	$4,271.7
Intangibles	$979.8	$1,056.1	$1,056.3	$1,052.7	$1,037.5	$1,085.9
Accelerated Dep. From ERP					$45.9	$45.9
Accelerated Dep. In "Certain Items"					$28.0	$27.7
Impact on Adjusted Operating Income					$17.9	$18.2
EPS Impact	$0.024	$0.025	$0.025	$0.024		

The accelerated depreciation will now be gone from comparisons going forward which will take away a more than 2 cents per share tailwind to growth.

Self-Insurance Expense Down for the Year

SYY maintains a self-insurance program to cover portions of its workers' compensation, general and vehicle, and property insurance costs. The following table shows the development of its insurance liability account for the last three fiscal years:

	6/30/2018	6/30/2017	6/30/2016
Beginning Balance	$245.8	$199.1	$193.3
Charged to Costs and Expenses	$461.9	$523.7	$418.9
Payments	-$436.7	-$476.9	-$413.2
Ending Balance	$271.0	$245.8	$199.1

While SYY does not disclose quarterly detail on the account, we can see above that for the fiscal year ended 6/18, expenses related to the plan fell by $61.8 million or approximately 8.5 cents per share. This accounts for about 12% of the reported increase in adjusted EPS for the year. Management references this in the discussion of operating expenses in its 10-K and attributes it to a "reduction in our estimates for our reserves for our self-insurance program." We consider this a material, non-operating benefit which is not likely to repeat going forward.

Lancaster Colony (LANC) 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 Lancaster Colony (LANC) with a 3+ (Minor Concern) rating.

Overall, we are not very concerned with LANC's quality of earnings but would point out the following two items:

- Inventory days of sales (DSIs) rose by over 3 days in the 6/18 quarter. Management indicated this was due to rising costs, volume growth in dressings and pre-buying. These explanations seem plausible and we are not overly alarmed by the increase. We will be watching the trend closely in the upcoming quarter.

- Accounts payable days (DSPs) rose by over 5 days as the company admittedly is stretching payment to suppliers. Given LANC's noticeably low level of payables, we actually consider this to be advisable and we do not consider this a negative at this point.

Inventory DSIs Rose

Inventory days of sales (DSIs) rose by 3.6 days over the year-ago quarter as seen in the following table:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Inventory	$91	$88	$78	$85
COGS	$232	$228	$236	$223
Inventory DSIs	35.7	35.2	30.1	34.8

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Inventory	$76	$80	$80	$90
COGS	$217	$222	$233	$211
Inventory DSIs	32.1	32.7	31.4	38.9

This is not an overly large jump and management addressed the inventory increase in the conference call:

> *"The increase in our inventory balances since June reflect higher commodity input cost, volume growth for our shelf stable licensed dressings and sauces, and an earlier pre-build of seasonal dip inventories for improved planned efficiencies."*

Given the manageable size of the increase and the inflationary environment, we are not overly alarmed by the jump in inventories. However, this is an area to be watching in the next quarter and should inventory remain elevated, it will become a more serious source of concern.

Accounts Payable Also Jumped

Accounts payable days also increased, continuing a trend of significant jumps seen in the last three quarters:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Accounts Payable	$58	$58	$53	$48
COGS	$232	$228	$236	$223
DSPs	22.8	23.3	20.4	19.5

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Accounts Payable	$41	$42	$39	$42
COGS	$217	$222	$233	$211
DSPs	17.4	17.2	15.4	18.0

While we would expect some increase in payables to match the rise in inventories, the 5-6 days year-over-year increases indicate something else is at work. As with the inventory increase, management addressed the issue on the call:

“The increase in our accounts payable since June largely reflects an emphasis by our procurement team to extend payment terms with our vendors in conjunction with our lean six sigma efforts.”

Actively stretching payment terms has been an almost universal theme in the packaged food group in the last several quarters. Some food companies have pushed payables days to extremely high levels, in some cases exceeding 80-90 days with the help of structured payable arrangements. Our concern with those companies is that they can only push so far and may face a backlash as suppliers push back and the game unwinds. In the case of LANC, the company’s days payable is quite low, to the point it is almost advisable that they increase them for the sake of prudent working capital management. Therefore, while we will continue to monitor the trend, we do not consider this issue a concern at this point.

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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