BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

October 25, 2018 | www.btnresearch.com

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AT&T – 3Q18 Update

It is clear that AT&T roiled the market with 3Q results showing a huge decline in TV customers despite saying in mid-September (11 weeks into the quarter), that raising its prices did not cause a huge drop off. We'll address this more fully in a moment. The quarter missed on EPS by 4-cents.

We think AT&T still represents a solid opportunity here after the Time Warner deal. We agreed completely with the market that the company likely overpaid there, but the stock already reflected that. One quarter after completing the deal, we are not changing our view that there is value here. In our September 20 report, we expressed our beliefd its 2019 forecasts were conservative and listed nine areas where it may be understated. Not included in those nine was the TV business, which has been disappointing for some time. AT&T reiterated its belief that it can stabilize the EBITDA there in 2019 and have it stop being a drag. The company confirmed its 2018 guidance at the high-end of forecasts for $3.50 in EPS which would need only $0.84 in 4Q vs. $0.85, $0.91, and $0.90 in quarters 1-3. It also

confirmed 2018 guidance at the high-end for free cash flow of $21 billion. With the stock is $30, trades for 8.6x EPS and about 6.5x EBITDA while paying a 6.7% dividend. This remains a cheap tech play in our opinion.

More importantly, the cash flow here is enormous and it has more levers to grow cash flow. They are on pace to retire about $16-18 billion in debt by the end of 2019, assuming no growth. Keeping the company at the same EBITDA level without any levers helping – that $18 billion would become $2.50 per share in stock value if the company continues to trade at 6.5x EBITDA in 2019. There's 8.3% potential capital appreciation along with a 6.7% dividend. Let's review the quarter:

- The TV business is unlikely to derail the forecasts. AT&T wants to reach a point where the decay in EBITDA stops. The trend is moving in the right direction despite 3Q customer numbers.

- AT&T's forecast for 2018 and 2019 Free Cash Flow forecast remains conservative.

- Completing large projects in 2018 and early 2019 should reduce capital spending in 2019 and boost Free Cash Flow by itself.

- Reviewing the nine areas for improvement in 2019 that doesn't include TV shows AT&T should be in good shape to hit and perhaps beat forecasts.

TV – Entertainment Group Results Dismal – Plan Remains to Stabilize EBITDA in 2019

Investors already knew that the traditional DirecTV business was suffering from cord cutting and that the new DirecTV Now service that works with broadband was growing rapidly but at a lower price point. The result was a plan where DirecTV Now would attract more customers than DirecTV Now was losing. And, DirecTV Now required no hardware, installation visits, etc. so it was higher margin. The company was seeing EBITDA drop during this transition and the forecast was that it would level off in 2019 and cease to be a drag on results.

Given that as a background, investors were excited to hear CEO Randall Stephenson announce in September that AT&T raised prices on DirecTV NOW and customer totals didn't drop-off. It sounded like AT&T had fixed one of its poorest performing divisions. So, it was a shock when 3Q18 numbers showed an accelerating loss of higher revenue DirecTV and DirecTV Now did not begin to offset the loss with new customers:

# in 000s	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18
Satellite Adds	0	-156	-251	-147	-188	-286	-359
U-Verse Adds	-233	-195	-134	-60	1	24	13
DirecTV Now Adds	72	152	296	368	312	342	49

The drop in EBITDA for the division was also more than pronounced with a drop of $454 million:

Ent. EBITDA	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18
EBITDA	$2,955	$3,106	$2,663	$2,368	$2,408	$2,608	$2,209
Margin	23.7%	24.8%	21.4%	18.9%	20.7%	22.3%	18.7%
Y/Y change	n/a	0.0%	-9.9%	-11.2%	-18.5%	-16.0%	-15.7%

The EBITDA drop also came following a sequential improvement in 2Q18. Here is the company's take on the situation:

- There was an extra week of NFL Sunday Ticket in 3Q vs. last year which added to costs. That will rebound in 4Q with one fewer week. 3Q17 was higher than normal with a big pay-per-view fight. Without those events, EBITDA would have fallen 14% and marked the 2nd quarter of slower decay.

- Eliminating prepaid DirecTV in Puerto Rico cost 32,000 subscribers in 3Q18.

- Reducing promotional pricing in 3Q18 is eliminating high churn, low-value customers

- Adding more WatchTV and slimmer packages for streaming has been a growth area that is EBITDA positive. Slimmer packages will control content price and align it with lower price point revenue streams.

- They are lapping a 2-year lock promotion for DirecTV and U-Verse which should boost prices in those areas.

We agree, eventually this will bottom out. The question is does it bottom out at $1 billion or closer to $2 billion per quarter? There are still over 19 million DirecTV customers and just under 2 million DirecTV Now customers – the move from the former to the new service will come at a lower price point. Does the expiration of the customer lock-up on a promotional price lead to higher customer losses in 4Q and 1Q? Three areas give some comfort here:

- AT&T's broadband build-out helps it capture its own DirecTV cord cutters as well as other cable company's customers. They do very well at this transition where the broadband is in place.

- There is much more broadband coming online in 4Q18 and 2019. AT&T currently sees a 40% increase in customer locations next year.

- Pricing is rising on TV and Broadband. Broadband numbers are still increasing, and T expects to add 1 million broadband customers this year.

- The company noted that on its forecasts for earnings and cash flow, they are using figures for TV below what analysts are using.

There is likely more room for cost-cutting in this division too given DirecTV Now does not have as much in set-up costs or equipment to purchase and retrieve. In the last two years AT&T has cut about 12% of operating costs versus a 9% drop in revenue so that is also a good sign.

We admit that we were excited to hear the statement about raising price and not losing customers because that made one of the warts here less an issue. We are disappointed with these Entertainment results. However, we did not highlight an improvement here as one of the nine reasons AT&T's future earnings and cash flow looked attractive. This one division is still cash flow positive with broadband and the potential for the new advertising analytics to help it out. It is unlikely to offset the other positives.

AT&T's Free Cash Flow Forecasts Still Conservative

For 2018, the company is projecting $21 billion in free cash flow. Through three quarters, it is at $14.4 billion. They will collect $1.3 billion in reimbursed capital spending from the FirstNet contract in 4Q, which gets them to $15.7 billion. Last year in 4Q, AT&T without Time Warner did $4.5 billion in Free Cash Flow which had $1.0 billion in employee bonuses after the tax reform. Just adding that together is $21.2 billion. That doesn't include a 4Q from Warner Media.

For 2019, the forecast is $25 billion. They start with $21 billion in 2018 and add back $2 billion in merger fees related to Time Warner as being one-time in nature. Then, Time Warner only had a 6-month impact on 2018 so they annualize it at a flat figure assuming no growth and get to $25 billion. None of that sounds aggressive to us.

Moreover, the company wants to pay down about $15-$18 billion in debt in 18 months (3Q18-4Q19). It will apply all Free Cash Flow after the dividend toward that. The dividend consumes $22 billion of cash flow over 18 months. 3Q18 and 4Q18 free cash flow should be over $13 billion plus $25 billion in 2019. Assuming no growth, no asset sales, no cost savings or revenue synergies – this basic plan works in our opinion.

Progress on the Nine Areas for Improvement from September 20, 2018 Report

1. **Mexico** has been an area where AT&T has been investing money and trying to expand operations. It eliminated a wholesale business in the quarter. However, the $3 billion buildout of LTE in Mexico is now basically done. The forecast is they should see improvements to cash flow simply because $1 billion in annual capital spending is finished. Plus, the hope is it will spur more subscriber growth and perhaps reduce the EBITDA drain and perhaps turn it positive in later 2019. Here are the recent results for AT&T Mexico:

Mexico	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18
EBITDA	-$121	-$109	-$126	-$63	-$96	-$69	-$115
Subscribers	12.6	13.1	13.8	15.1	15.6	16.4	17.3

Stripping $1 billion in capital spending off, is a positive swing in free cash flow of about $600 million. If they can make the EBITDA drain go away, that's a bonus.

2. **Fiber buildout** is expected to be largely complete by the 1H19. That should help revenues and cash flow with more customers. It should also lower capital spending and boost Free Cash Flow.

3. **WarnerMedia Synergies** – the company's guidance is they are on track for $1.5 billion in cost savings and $1.0 billion in revenue gains over three years. These are not in the AT&T forecast for 2019.

4. **FirstNet is rolling out ahead of schedule.** There are already 250,000 subscribers on it. Revenue and cash flow should be rising going forward. AT&T spent $0.5 billion on support and training on FirstNet that is not reimbursed which won't recur in 2019.

5. **FirstNet rollout saves on capital spending** as AT&T installs 5G equipment on same towers as FirstNet equipment is installed.

6. **5G deployment running ahead too.** 5G will roll out in 12 cities in 2018. More cities will be added in 2019 and new handsets will be available in 2018 for 5G. There is only capital spending for all this in 2018, essentially no revenue and cash flow that should appear in 2019 still being forecasted at $0 in the AT&T outlook.

7. **5G Evolution from the spectrum will be in 400 markets by year-end.** The fiber buildout works toward this too. Much faster speeds for customers should bring in new business, slow churn, allow for more mobile entertainment too.

8. **WarnerMedia is growing.** In the 3Q18, revenues were up 6.5% and EBITDA up from $2.5 billion to $2.7 billion. This follows a history of steady growth at Warner. Yet, AT&T's forecast adds no growth in this area.

9. **Wireless was 2% on service revenue**, had a 9% increase in customers and EBITDA was flat. The EBITDA was impacted by higher iPhone sales as equipment revenues rose 19%. Equipment sales pressure margins. Going forward, equipment sales should decrease, and margins expand. There is no growth forecast here either. 5G, 5G Evolution, Fiber should be helping here.

We believe these areas add up to much more than what the TV business is doing. The Entertainment Unit did $9.6 billion in EBITDA for the last 4Qs. Even though broadband is expected to grow, let's assume the company sees $1 billion in lower annual results there until it starts to level off toward the end of 2019. That simply won't derail the total company forecasts because too many positives are not built in.

For example, lower Mexico capital spending may be $600 million in the positive and another $500 million is saved from FirstNet training. There's $1.1 billion. The $200 million in EBITDA growth at WarnerMedia was only one quarter. Even the growth slows – a full year of growth there should be a decent figure. Will people sign up for 5G and 5G Evolution and help revenues and cash flow in 2019? Will that cut churn in Wireless?

We don't like the TV results either, but that one segment is being given too much weight in this total equation. If AT&T improves that situation, this company has one more area for growth. If the company doesn't, TV dilutes improvement in other areas, but it's not big enough to offset the gains. In the meantime, find another stock with a reasonable deleveraging plan that could deliver over 8% capital appreciation potential without multiple expansion with the stock also paying 6.7% in dividends, that you can buy under 9x EPS.

Philip Morris (PM) – 3Q18 Update

We will need the 10-Q to update our *EQ Review* of a 3- (Minor Concern) rating to see the movement in receivables, inventories and changes in receivables sold. One of our concerns was that PM was stretching working capital. Overall, we saw that working capital was a $1.0 billion drain on cash flow in 3Q as current assets less cash declined producing $0.8 billion in cash as current liabilities less LT debt classified as current fell as well consuming $1.8 billion in cash.

We are keeping a neutral rating on the stock for fundamental reasons. The negatives of offsetting weak volumes and FX with pricing still seems like a tough proposition in the long run. But, the introduction of heated tobacco products into new markets continues to provide some lumpy growth and there are many more markets to expand heated tobacco still. At this time, that is a big tailwind to try to fight.

After 3Q results, not much has changed on the surface from our September 13 report except there are areas of guidance that came down further:

- Guidance on revenues, EPS, FX, and Japan's inventory channel all came down on the 3Q18 press release.
- Initial stocking of Heated Tobacco devices and refills is helping.
- Early heated tobacco markets are not showing much growth after a year.
- Price increases are still driving earnings growth and PM has little cushion on dividend payout ratios staying under 100% of EPS and FCF if pricing power does not hold.

Guidance Continues to Fall:

After missing on forecasts for nearly all of 2016 and 2017, PM has now beaten forecasts in each quarter of 2018. However, at the same time, it continues to lower guidance.

Constant currency revenue growth for 2018 was forecast at over 8% in the 4Q17 press release. It was dropped to 8% after 1Q18. It fell to 3%-4% after 2Q18, and now was reduced to just 3%.

EPS growth was expected to benefit from 16-cents of FX for 2018 in 4Q guidance and 1Q guidance. That benefit was forecasted to fall to a 7-cent negative impact in 2Q and 12-cents negative in 3Q guidance. We adjusted the 2018 EPS forecasts for this FX impact, and see that the top end of EPS guidance is falling and growth rate range is falling too:

FX adj EPS	EPS Low	EPS High	EPS Growth
4Q17	$5.04	$5.19	7%-10%
1Q18	$5.09	$5.24	8%-11%
2Q18	$5.09	$5.19	8%-10%
3Q18	$5.09	$5.14	8%-9%

We want to again point out that PM also cut guidance for its tax rate from 28% to 26% to 24% during this time. A 200bp move in the tax rate is worth about 13-cents in EPS.

At the same time, the inventory overhang for heated tobacco in Japan that hurt 2Q sentiment so much may have become worse again. After 2Q, guidance was for shipments of 41-42 billion units of heated tobacco in 2018 after a 3-billion-unit inventory reduction in Japan. After 3Q, guidance remains for shipments of 41-42 billion units. However, now the inventory reduction in Japan is 4 billion units offset by 1 billion units of growth in other markets.

The CFO was asked point blank on the call how they can be beating in quarters 1-3 and forecasting a weak 4Q to bring EPS growth down so much? The answer was:

- 4Q17 had a 7-billion-unit inventory build in Japan vs flat in 4Q18
- Another 1.5 billion sticks impacted in 4Q18 by distributors buying in 3Q18 ahead of a price increase
- A bigger part of the incremental $600 million of support spending for heated tobacco launches will fall in 4Q18

In our view, the tax rate alone should be pushing up forecasts. That the top end of guidance continues to be reduced is puzzling.

Heated Tobacco Helps Early On

As we said in September, PM's results are going to be helped as heated tobacco rolls out into new markets. It gets to stock inventory as well as the devices needed to use heated tobacco and those devices cost more. They book revenues when it sells product to distributors so initial stocking can provide a good boost. Growth continues for several quarters too. It comes at the expense of combustible cigarettes, but people are already expecting those to decay. That is the basic story why we are not more negative on PM at the moment. That is a big tailwind to fight this early in the roll-out.

Early results in Japan and Korea show that the market share gains are rapid, but they also are showing signs of stalling quickly too. Here is the market share of PM's heated tobacco in Japan and Korea:

HTU Market Share	3Q17	4Q17	1Q18	2Q18	3Q18
Japan	11.9%	13.9%	15.8%	15.5%	15.5%
Korea	2.5%	5.5%	7.3%	8.0%	7.4%

This is why the company and many investors are excited. Heated tobacco grabbed some big market share very quickly. However, 2Q18 results disappointed because PM announced that it would be adjusting inventory levels down in Japan by 3 billion units. In 3Q18, the forecast is a 4-billion-unit reduction in Japan. The success attracted competition and price cutting on devices has already begun. The result is rapid growth in 4Q17 quickly vanished:

Asia Results	4Q17	4Q16	change
Cigarette Vol	61,234	63,815	-2,581
Heated Vol.	14,032	3,510	10,522
Total Vol.	75,266	67,325	7,941
Asia Op Inc.	$1,396	$908	$488

- In 2017, Japan and Korea were in the Asian division before moving to the East Asia & Australia segment in 2018 so the numbers are not completely comparable.

E. Asia & Aust.	1Q18	1Q17	change
Cigarette Vol	14,091	17,243	-3,152
Heated Vol.	7,342	4,145	3,197
Total Vol.	21,433	21,388	45
Asia Op Inc.	$515	$472	$43

E. Asia & Aust.	2Q18	2Q17	change
Cigarette Vol	15,114	15,790	-676
Heated Vol.	7,838	5,726	2,112
Total Vol.	22,952	21,516	1,436
Asia Op Inc.	$498	$510	-$12

E. Asia & Aust.	3Q18	3Q17	change
Cigarette Vol	14,186	15,331	-1,145
Heated Vol.	4,575	8,826	-4,251
Total Vol.	18,761	24,157	-5,396
Asia Op Inc.	$426	$648	-$222

The growth vanished with destocking and changes in operating income become negative. In our view, the bigger problem is PM went from getting big gains in volume and pricing to getting little or negative impacts on operating income from both and this happened quickly:

Oper. Inc. Chg. E. Asia & Aust.	4Q17	1Q18	2Q18	3Q18
Volume	$471	$46	$99	-$307
Price	$114	$15	-$36	$86
FX	-$97	$16	-$5	-$6

The company is predicting that once this destocking is complete in Japan, it will set the stage for future growth in Japanese heated tobacco volumes. We think that ignores that the market share gains have stalled. It should level off at 8 billion units per quarter in East Asia – which is up from 3Q18 figures of 4.5 billion, but does it become flat at those levels and offset by falling cigarette volumes?

While we do not see heated tobacco as the panacea to all the problems facing PM, it is obvious that the early stage roll-out of this product in new markets can spur some growth. As it is now rolling out in some European markets and Russia, growth in those markets is still in the infancy:

HTU Market Share	3Q17	4Q17	1Q!8	2Q!8	3Q18
Eur. Union	0.3%	0.6%	0.8%	1.0%	1.2%
Russia	0.1%	0.2%	0.5%	0.8%	1.1%

These markets are also larger than Japan. In 2016, PM sold 43.9 billion cigarettes in Japan. The EU bought 440% more and Russia 180% more in 2016. So, market share points are

worth more in these new markets and there is still the Philippines, Turkey, Indonesia where volumes are very high too.

Higher Taxes and Prices Continue to Hurt Volumes - PM May Be Too Dependent on Pricing

We talked about how many countries are seeking to curb smoking and raise revenue by boosting excise taxes. Given how many countries PM operates in, there are often several countries where taxes are on the rise in any given quarter. Higher taxes paid at retail are the same as a price increase for the consumer. Higher prices drive down volume. Excise tax increases hurt 3Q18 volume in France by 8.6%, Russia 7.8%, and Ukraine 9.4%.

The plan from PM is to boost prices to offset volume decay. When taxes are raised, and volumes fall, that just hurts PM. They will try to push through some pricing for themselves, but it unlikely fully offsets the lost volume. Among countries that saw price hikes hurt volume are Argentina down 8.5%, Brazil down 12.5%, North Africa down 4.4%, and Italy down 2.4%.

Overall, pricing continues to be the only thing driving results in 3Q:

3Q Op. Income	Price	Volume	FX	Cost	Total
Europe	$77	$110	$19	-$52	$154
East Europe	$91	-$10	-$56	$1	$26
M/E Africa	$19	$59	-$97	$15	-$4
S&SE Asia	$150	-$18	-$43	-$45	$44
E. Asia & Aust.	$86	-$307	-$6	$5	-$222
Lat Am & Can	$60	-$26	$16	$20	$70
Total	$483	-$192	-$167	-$56	$68

For the 3Q, pricing was worth $483 million in higher operating income from the various segments and the total gain was only $68 million. There are three things to focus on in this equation beyond the Japanese and Korean situations described above for the huge negative volume figure. First, the roll-out of heated tobacco in Europe and Eastern Europe helped even more because it improved volume too.

Volume	1Q18	2Q18	3Q18
Europe	-$67	$19	$110
East Europe	-$47	-$41	-$10

Cigarette volume was actually down 2% in Europe and 6% in Eastern Europe for 3Q. We also believe that as a roll-out for heated tobacco increases, people need to buy the device to use heated tobacco. Those add to pricing because they cost more.

The Middle East volumes were helped by lapping some earlier excise tax increases. Saudi Arabia was up 19% in 3Q after being down 41% in 1Q and 24% in 2Q. We would expect this to help in 4Q volume too. However, keep in mind that Martin King of PM also noted that one of the reasons for low guidance in 4Q is that 1.5 billion units in Japan were likely pulled into 3Q ahead of 4Q price increases. That already inflated 3Q volume figures.

In our opinion, the tax increases will continue as we noted in September plus there is also pressure to boost taxes on heated tobacco. Even PM acknowledges that the tax hikes accelerate volume cuts. The benefits of initial stocking for heated tobacco aside, we do not believe PM can continue offset higher costs, FX issues, and weaker volume all with price hikes for very long. There are mentions of illicit trade and smokers trading down as other negative impacts in PM's earnings discussions that are also the result of higher pricing.

We point this out because it simply doesn't take much decay to hurt the dividend sustainability. The current dividend is $4.56 with guidance of EPS of $5.09 without FX impacts forecast to be negative. That's a 90% payout prior to FX. On cash flow, the company continues to forecast $9.0 billion in Cash from Operations less $1.5 billion in capital spending or $7.5 billion in free cash flow. The dividend is $7.1 billion or a 95% payout ratio.

Share repurchases have stopped and spending to support heated tobacco roll-outs is rising. If the company cannot get pricing gains at historic levels, it becomes difficult to envision the dividend growing at rates investors have been accustomed.

Healthcare Services Group (HCSG)- 9/18 10-Q Review

HCSG released its 10-Q and the results now look even worse in our opinion. Moreover, we are not seeing evidence that DSOs are falling at all despite management's claims that it is cutting payment terms in half for many customers.

- Management claims it is pushing customers to pay faster and started that process 2-year ago and now more than one-third pay in less than 30 days.
- Receivables continue to rise faster than sales and L-T Notes are rising faster too.
- HCSG moved some bad debt allowance to L-T Notes receivable for the first time.
- DSOs continue to increase to historically high levels despite claims that collection frequency is increasing.
- Bad debt expense and write-offs last quarter were higher than entire recent years.

Here are the statements from HCSG officers on the 3Q18 call:

> Ted Wahl CEO:
> ***"Strengthening customer payment terms and conditions, which includes increasing customer payment frequency from monthly to semi-monthly or semi-monthly to weekly payments****, with the goal of collecting what we bill and having operating cash flows approximate net income, and replenishing the management pipeline with the goal of being prepared for the next wave of growth in 2019 and beyond.*
>
> Matthew McKee COO:
> *"This process for us, you could go back to* ***the formative stages of the company when the original billing was done on a weekly or bi-weekly basis. Over the years, there was a migration to a monthly billing system and process rather than a weekly or bi-weekly. A couple years ago, we started the migration back for a couple reasons.*** *One, and most importantly for us, it gives great visibility into the customer. Having four look-sees or two look-sees a month versus one at the end of the month provides us with a whole different level of visibility as well as a more constructive conversation if and when there's a shortfall."*

"From a customer perspective, it lines up better with either their own payroll cycle they had as well as their revenue stream, whether it be from the Medicare and Medicaid or insurance programs they may be part of. So, it's win-win. That's the way we think about it. That's the way we've approached it. It's been positively received. Here we are two years into this focus, this strategy, which is a migration."

"It's a process, not an event, but more than a third of our customers are now paying us on something other than an end of month payment. *We'll continue to have those conversations with our customers and where it makes sense for both of us, we'll have that change take place. But again, very well received and something we look forward to continuing into the future."*

HCSG's summary is - the company was built on weekly and bi-weekly payment terms, which migrated to monthly. For two years, HCSG has been pushing payment terms back to weekly and bi-weekly. More than one-third of customer now pay in less than a month.

We see no evidence of this looking at the company's receivables:

	3Q18	2Q18	1Q18	4Q17	3Q17
Gross A/R	$392.1	$393.4	$383.9	$390.7	$376.8
allowance	$38.6	$49.7	$48.9	$12.0	$9.8
Net A/R	$353.5	$343.7	$335.0	$378.7	$367.0
LT Notes Rec.	$55.9	$37.4	$38.8	$15.5	$11.5
Allowance	$10.0	$0.0	$0.0	$0.0	$0.0
Net LT Notes Rec.	$45.9	$37.4	$38.8	$15.5	$11.5
Total Gross	$448.0	$430.8	$422.7	$406.2	$388.3
Total Net	$399.4	$381.1	$373.8	$394.2	$378.5

Several things jump out at us. First, for the first time, the company recorded a bad debt allowance for Long-Term Notes receivable. We already find it odd that a company that wants to have credit terms of 7-14 days is extending credit for over 1-year. Second, the short-term receivables are not declining at all. This runs counter to the statements that they have been accelerating collections for two years now. Third, the company continues to move more receivables to long-term notes.

Any way we calculate DSOs for receivables in any manner that shows they are rising. This is largely because there is very poor sales growth and the company is guiding to a $10 million revenue headwind from cutting payment terms.

	3Q18	2Q18	1Q18	4Q17	3Q17
Sales	$506.9	$503.7	$501.8	$499.4	$491.3
Seq. Sales Growth	$3.2	$1.9	$2.4	$8.1	$20.4

We are looking at growth rates in total gross receivables, total net receivables, and total net receivables less net promissory notes. All are growing faster than sales sequentially:

	3Q18	2Q18	1Q18	4Q17	3Q17
Total Gross A/R	$448.0	$430.0	$422.7	$406.2	$388.3
Seq. Gross Change	$18.0	$7.3	$16.5	$17.9	$34.5
Total Net A/R	$399.4	$381.1	$373.8	$394.2	$378.5
Seq. Net Change	$18.3	$7.3	-$20.4	$15.7	$32.6
Net Prom. Notes	$66.5	$59.4	$60.9	$36.6	$31.9
Seq. Change	$7.1	-$1.5	$24.3	$4.7	$10.7
Net current A/R	$332.9	$321.7	$312.9	$357.6	$346.6
Seq. Change	$11.2	$8.8	-$44.7	$11.0	$14.0

- Total Gross A/R is A/R + N/R + allowances
- Total Net A/R is Gross A/R less allowances
- Promissory Notes are net of allowances and are listed in short-term and long-term receivables
- Net current A/R is short-term receivables less short-term promissory notes less allowances for short-term receivables.

The large bad debt expense recorded in 1Q18 skews the net figures and allows net receivables to appear to fall in that quarter only. Notice that total Net receivables is already higher than 4Q17 again despite having loss allowances of $48.6 million vs. $12.0 million. Sales are only up $7.5 million from 4Q17 with net A/R up $5.2 million even after the giant charge. Gross receivables are essentially rising at 2-6x the rate of sales.

The company will argue that people should ignore the big increases in promissory notes because that those arose before they started to clamp down on slow paying customers. So, we even pulled all promissory notes out of the equation and just focused on short-term receivables net of all promissory notes and allowances. Those are the best of the best. Those are also growing faster than sales!

	3Q18	2Q18	1Q18	4Q17	3Q17
Total Gross A/R	$448.0	$430.0	$422.7	$406.2	$388.3
DSO	80.4	77.7	76.7	74.0	71.9
Total Net Rec.	$399.4	$381.1	$373.8	$394.2	$378.5
DSO	71.7	68.9	67.8	71.8	70.1
Net current A/R	$332.9	$321.7	$312.9	$357.6	$346.6
DSO	59.8	58.1	56.7	65.2	64.2

The DSOs are not declining under even the best definition – leaving out all long-term and short-term promissory notes and pushing down the receivables figure with the huge bump

in allowances. It does not appear to us that this is a company that is now collecting more than one-third of customer receivables in under a month.

The company noted that its receivables were up because the quarter fell on a weekend. We didn't give that much credence because the HCSG was still cooking meals and doing laundry on the weekend too and thus generated sales too. Even if we adjust for that and take $10 million off the Net current A/R total and take 2 days of sales off too: we end up with a DSO of more than 56 days. On a gross A/R basis it would be 79 days and remain the highest yet seen.

Moreover, from an annual basis – we have never seen Total Net Receivables DSOs even close to 30 days. We have shown this table before:

	2017	2016	2015	2014	2013	2012	2011	2010	2009
DSO	77.1	65.1	55.3	57.4	61.9	48.1	54.3	53.5	57.4

	2008	2007	2006	2005	2004	2003	2002	2001	2000
DSO	60.4	56.2	61.3	49.9	50.5	63.5	68.3	69.5	75.6

Historically, DSOs move up in recessions and down in better times. DSOs are never under 30 days. Remember, 2018 is running higher than 2017, which was the all-time high. Where is the recession in the US? There isn't one, however, HCSG customers are being squeezed by rising wages, lower occupancy, and flat to down rents. Their cash bind is showing up on the HCSG balance sheet.

As far as customers paying them after being converted to long-term, write-offs are also accelerating:

	3Q18	2Q18	1Q18	2017	2016	2015
Bad Debt Exp.	$3.0	$2.3	$37.1	$6.2	$4.6	$4.3
Write-offs	$4.1	$1.4	$0.2	$1.1	$2.3	$5.9

From 2011-2014, annual write-offs were about $2-$3 million per year. In 3Q18 alone, the write-off of bad debt was $4.1 million. Bad debt expense used to run $2-$3 million per year also. It rose to over $4 million in 2014-2015. Now it's running $2-3 million per quarter.

Kimberly-Clark (KMB) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	4+

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

We are lowering our rating on Kimberly Clark (KMB) to 4- (Acceptable).

KMB reported adjusted EPS of $1.71 in the 9/18 quarter which was 8 cps above the consensus targets. However, the adjusted effective tax rate dipped 3.4 percentage points sequentially. We don't know what the average consensus estimated tax rate was going into the quarter, but we estimate the decline in effective rate would have added at least 7 cps to the average analyst's models, likely more. This takes the shine off the headline earnings beat and is the main factor behind the slight lowering of our rating. In addition, negative FX translation shaved 3 percentage points off sales growth in the period. We saw no other new earnings quality issues and note the following development of previously cited issues:

- The decline in inventory DSIs continues, but our concerns of a "LIFO liquidation" are further diminished by the increase in inventories accounted for under LIFO. We note that there was a year-over-year jump in LIFO finished goods inventories. However, much of that appears to be a rebound from lower 2017 balances and we are not overly concerned at the present.

- While other assets increased, this appears to be largely due to rising time deposit balances.

Lower Tax Rate Benefits Results

Like many companies with slow core growth, much of KMB's recent EPS growth has come from the lower corporate tax rate. However, KMB saw its adjusted effective tax rate fall even further in the 9/18 quarter. The following table shows the adjusted effective tax rate for the last three quarters as well as the forecast tax rate for full-year 2018 as of the end of each quarter:

	9/30/2018	6/30/2018	3/31/2018
Adjusted Effective Tax Rate	19.6%	23.0%	22.0%
Forecasted Full-Year Rate	21-22%	23-26%	23-26%

There was a clear drop off in the sequential adjusted effective tax rate which the company attributed to "planning initiatives". While certainly a positive, the decline was likely not anticipated in analysts' models. If we assume that analysts were anticipating an effective rate of 23% going into the quarter, the lower-than-expected decline would have been a more than 7 cps boost to adjusted EPS. Realistically, models were likely expecting the effective rate to be higher than 23%, implying an even larger boost. With this in mind, the $0.08 per share earnings beat looks much less impressive.

Inventory DSIs Declining with LIFO Portion Increasing

We noted two quarters ago that KMB's inventory days of sales (DSIs) were trending down which warranted observation since about 30% of inventories (most US inventories) are accounted for under the LIFO (last-in, first-out) method. A decline in LIFO inventories can artificially inflate profits as older, lower-cost inventory layers are matched up with current sales on the income statement. However, the decline in LIFO inventories fell more in-line with the decline in FIFO inventories in the 6/18 quarter, which alleviated some of our concern. As the following table shows, the decline in total inventory DSIs continued into the 9/18 quarter, but LIFO inventory DSIs actually climbed to 13.5 days from 12.7.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017	9/30/2017	6/30/2017
LIFO Inventory						
Raw Materials	$83	$86	$86	$87	$88	$89
Work in Process	$120	$108	$102	$110	$106	$110
Finished Goods	$450	$453	$412	$421	$396	$440
	$653	$647	$600	$618	$590	$639
Excess FIFO cost over LIFO cost	-$184	-$177	-$178	-$176	-$173	-$165
Total LIFO Inventory	$469	$470	$422	$442	$417	$474
LIFO Inventory Days of Sales	13.5	13.6	11.3	13.7	12.7	14.8
FIFO/Average Cost Inventory						
Raw Materials	$252	$247	$266	$258	$249	$251
Work in Process	$106	$99	$101	$103	$97	$87
Finished Goods	$664	$654	$685	$684	$687	$632
Supplies	$279	$280	$304	$303	$298	$294
Total FIFO/Average Cost Inventory	$1,301	$1,280	$1,356	$1,348	$1,331	$1,264
FIFO/Average Cost Inventory Days of Sales	37.5	37.1	36.3	41.8	40.5	39.4
Total Inventory Days of Sales	51.0	50.7	47.6	55.6	53.2	54.2

While the increase in LIFO inventories may alleviate the concern of a LIFO liquidation, the rapid increase also brings with it some concern, particularly the near-14% increase in LIFO finished goods. To get a better feel for the trend in US inventories, we need to track them relative to US results. The company breaks out sales for North America which primarily reflects the US. While we ordinarily calculate DSIs with cost of sales to eliminate the impact of sales prices changes, revenue is close enough to give us an idea of the rough DSI trend. However, we note that North American revenue in the 9/18 quarter fell by 5% while volumes actually declined by 8%. This means that overall inventories moved in the quarter less than the sales figures indicate implying that the most recent sales-based DSI figures in the table below are likely understated.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
North American Sales	$2,407.00	$2,347.00	$2,385.00	$2,295.00
LIFO Finished Goods	$450.00	$453.00	$412.00	$421.00
LIFO FG DSI (on sales)	17.1	17.6	15.8	16.7

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
North American Sales	$2,428.00	$2,379.00	$2,324.00	$2,352.00
LIFO Finished Goods	$396.00	$440.00	$444.00	$430.00
LIFO FG DSI (on sales)	14.9	16.9	17.4	16.7

	9/30/2016	6/30/2016	3/31/2016	12/31/2015
North American Sales	$2,410.00	$2,410.00	$2,373.00	$2,350.00
LIFO Finished Goods	$442.00	$472.00	$499.00	$525.00
LIFO FG DSI (on sales)	16.7	17.9	19.2	20.4

We would point out that there was a downward trend in US finished goods in 2017, so much of the recent year-over-year increase in US finished goods inventories is due to a rebound. Also keep in mind that the LIFO finished goods number above is before the LIFO adjustment, so it still contains the most recent, higher-cost inventory. This means at least some of the increase is due to the rising costs the company is experiencing. With all of these factors in mind, we are not overly concerned by the rise in LIFO finished goods, but the trend should be watched closely in future quarters.

Other Assets Increase- Not a Concern

While other current assets and other assets rose in the quarter, this now appears to be related to the company's time deposits balance. We currently see no concern of increased capitalization of expenses.

Procter & Gamble (PG) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3+

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

We are lowering our rating of Procter & Gamble (PG) to 3- (Minor Concern).

PG's adjusted EPS of $1.12 topped the consensus estimate by 3 cps in the 9/18 quarter. However, while our view of overall earnings quality has not deteriorated enough to warrant a 2 "Weak" rating, conditions did deteriorate, prompting us to lower our rating to 3- (Minor Concern) from 3+.

- Accounts payable days (DSP) jumped almost 6 days from the year-ago quarter to over 110 days as management continues to cite extending payment terms with suppliers. The current DSP represents a historical high and is near the top end of the group. We are skeptical of how much further this can be pushed to boost cash flow.

- An increase in the number of anti-dilutive shares and out of the money options from the diluted share base added 3 cps to diluted EPS in the quarter. This amount equals the reported earnings beat in the period.

- FX translation turned against the company in the 9/18 quarter, shaving 3% off sales growth and $0.10 per share off EPS. Further deterioration is not accounted for in guidance and the company was open in cautioning that price increases to offset FX and commodity pressures will not be felt until later in the 12/18 quarter.

- Advertising as a percentage of sales fell by 100 bps in the quarter. We estimate about half came from the impact of an accounting change with the rest due to leverage and savings. Given the company's push to combat rising costs with price increase, we are skeptical margins can continue to benefit in the advertising area.

Payables Resumed Their Rise

We noted earlier in the year that PG's accounts payables were rapidly outgrowing cost of sales, leading to a rise in days payables (DSPs) and a corresponding benefit to cash flow growth. While this trend moderated in the 6/18 quarter, it began again in the 9/18 quarter as DSPs jumped to over 110 days from 104.4 in the year-ago period and 105 in the previous quarter:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$8,484	$8,989	$8,343	$8,667
Accounts payable	$10,243	$10,344	$9,716	$9,740
Accounts payable DSPs	110.2	105.0	106.3	102.5

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$8,269	$8,299	$7,836	$8,298
Accounts payable	$9,458	$9,632	$8,076	$8,300
Accounts payable DSPs	104.4	105.9	94.0	91.3

The company cited extended payment terms with suppliers as a reason for the increase in payables in the liquidity section of its 10-Q filing. We are somewhat surprised by the sudden resurgence of payables growth given that management warned in the 10-K filing for the year ended 6/18 that it anticipated the "cash flow benefits from the extended payment terms could decline slightly over the next fiscal year." The 110 days registered in the 9/18 quarter represents a distinct recent historical high and we do not expect such a benefit to continue.

Exclusion of Anti-Dilutive Shares

Like all companies, PG excludes shares related to out of the money options or shares that are anti-dilutive (total proceeds upon exercise would have exceeded the market value of the underlying common shares.) The impact of the exclusion of anti-dilutive shares is seldom material to diluted EPS, but we note that it was material for PG in the 9/18 quarter. The following table shows reported diluted shares adjusted for excluded shares and the associated impact on diluted EPS:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Diluted shares	2,612.1	2,529.3	2,645.6	2,669.6
Shares Excluded	69.0	NA	54.0	24.0
Adjusted Share Count	2,681.1	2,529.3	2,699.6	2,693.6
Adjusted Net Income	$2,915	NA	$2,649	$3,174
Reported Diluted EPS	$1.12	NA	$1.00	$1.19
Diluted EPS on Adjusted Share Count	$1.09	NA	$0.98	$1.18

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Diluted shares	2,690.6	2,741.7	2,705.5	2,737.6
Shares Excluded	20.0	NA	7.0	27.0
Adjusted Share Count	2,710.6	2,741.7	2,712.5	2,764.6
Adjusted Net Income	$2,928	NA	$2,592	$2,956
Reported Diluted EPS	$1.09	NA	$0.96	$1.08
Diluted EPS on Adjusted Share Count	$1.08	NA	$0.96	$1.07

We can see that the increase in shares excluded from the diluted share count beginning in the 3/18 quarter which is likely the result the rapid share price decline at the beginning of the year. (Note that PG does not disclose share excluded from the fourth fiscal quarter periods.) Had it not been for the increase in the number of excluded shares, diluted EPS would have been 3 cps lower in the 9/18 quarter. We are skeptical that analysts' models are detailed enough to anticipate this impact which casts a shadow on the 3 cps EPS beat in the quarter.

FX Impacts

PG, like many companies, is seeing a growing negative impact from foreign currency translation. FX rates shaved 3% off of sales growth in the period, completely erasing the benefit of the 3% growth in volumes. Management quantified the bottom line impact of foreign exchange as a negative $0.10 per share and stated:

> *"In less than the three months since our last earnings release, the foreign exchange headwind on earnings increased by $400 million after tax, $900 million in total for the fiscal year. The Turkish lira devalued 25%, the Argentine peso more than 40%, the Indian rupee nearly 10%."*

Management noted in the conference call that current guidance does not take into consideration further deterioration of the FX position and also cautioned that price

increases put in place to combat both FX and rising commodity costs will not take effect until later in the 12/18 quarter.

Cuts to Marketing

We note that the company cited lower advertising and promotion spending as a percentage of sales being a benefit to margins in the quarter.

> *"Marketing spending as a percentage of net sales decreased 100 basis points due to the positive scale impacts of the organic net sales increase, savings in agency compensation, production costs and advertising spending, and the impact of adopting the new standard on "Revenue from Contracts with Customers" which prospectively reclassified certain customer spending from marketing (SG&A) expense to a reduction of net sales."*

Note that if the new revenue standard had been in effect in the 9/17 quarter, it would have resulted in $77 million of advertising and promotional expense being reclassified as a reduction of sales. This represented about 45 basis points of revenue in the year-ago period, so we estimate about half of the 100-bps decline could have come from the change in accounting treatment. While advertising leverage is possible, the fact that the company is simultaneously trying to push through price increases to cover rising raw materials costs may require an increase in overall promotional and advertising expense, so we are hesitant to expect much more in the way to margin benefits from this area.

Illinois Tool Works (ITW) EQ Review Initial Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3-

ITW reported 9/18 adjusted EPS of $1.90 which beat the consensus by 2 cps. However, the company missed revenue targets as sales were pressured by lower automotive activity in Europe and China as well as FX pressures. We will need the 10-Q filing to do a final rating for the quarter, and for now, we maintain our *EQ Review Rating* of 3- (Minor Concern). We note the following observations based on the numbers in the press release:

- DSOs jumped almost 3 days over the year-ago period and reached a multi-year high. We will be looking for commentary on receivables in the 10-Q along with the deferred revenue balance. We will view another sequential decline in deferred revenue with concern.

- DSIs jumped by almost 5 days over the year-ago quarter. Some of this increase almost certainly reflects rising raw materials costs and the use of FIFO accounting for the bulk of its inventories. However, the sudden acceleration in the DSI increase could also indicate an unplanned buildup of product and increases the risk of future discounting.

Receivables DSOs Continue to Trend Higher

We have noted in past quarters that accounts receivable days of sales (DSO) were rising and this trend continued into the 9/18 quarter:

	9/30/2018	6/30/218	3/31/2018	12/31/2017
Sales	$3,613	$3,831	$3,744	$3,629
Accounts Receivable	$2,777	$2,878	$2,874	$2,628
DSOs	70.1	68.6	70.0	66.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$3,615	$3,599	$3,471	$3,399
Accounts Receivable	$2,672	$2,629	$2,534	$2,357
DSOs	67.4	66.7	66.6	63.3

While the pace of year-over-year growth in DSO moderated somewhat in the 6/18 quarter, the widening of the gap accelerated to 2.7 days in the 9/18 quarter. We know that the company is working to push through higher prices to combat both rising raw materials costs and tariffs. However, this should be reflected in both sales and receivables numbers and not have a material impact on the DSO trend. Therefore, we view the almost 3-day increase in DSO with growing concern. Also, when we get the 10-Q filing for the quarter, we will be paying close attention to the company's deferred revenue balance. PG will still not be reporting a year-ago number to compare to which will limit the potential insight, but another sequential decline in deferred revenue will add to our concern about the quality of the 9/18 quarter's revenue.

Inventory Balances Also Jumped Again

In addition to rising receivables, we have observed that inventory days (DSIs) have been increasing. The rate of increase accelerated in the 9/18 quarter.

	9/30/2018	6/30/218	3/31/2018	12/31/2017
COGS	$2,096	$2,231	$2,181	$2,125
Inventory	$1,338	$1,320	$1,335	$1,220
Inventory DSIs	58.3	54.0	55.9	52.4

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$2,092	$2,087	$2,003	$2,006
Inventory	$1,225	$1,199	$1,158	$1,076
Inventory DSIs	53.4	52.4	52.8	48.9

Despite essentially flat cost of sales, inventory at the end of the 9/18 quarter jumped by over 9% from the year-ago period, resulting in a 4.9-day increase in DSI. Some of this increase likely reflects rising raw materials prices. A little over 20% of the company's inventories are accounted for under the LIFO (last-in, first-out) method with the balance accounted for under FIFO (first-in, first-out). This means that for the bulk of inventories, the newer, higher cost inventories remain on the balance sheet longer before being recognized in cost of sales with the delay approximating around 60 days. ITW has been increasing prices for several quarters and noted in the 9/18 quarter commentary that price increases are now offsetting raw materials cost increases on a dollar-for-dollar basis. Still, the rising inventory balances are evidence that there are higher-cost inventories still waiting to be recognized. Note that ITW does not hedge its raw materials purchases.

Additionally, given that raw materials costs have been increasing for some time, the sudden acceleration in the DSI increase coupled with the admitted lower-than-expected performance in certain segments of the business leaves open the possibility that there was an unplanned buildup in inventory in the period, increasing the risk of future discounting to move those products. Again, we will be looking for more color on the inventory increase when the 10-Q is released.

Explanation of EQ Rating Scale

Rating	Description
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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