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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Contents

Altria (MO) 3Q Update p. 1
Welltower (WELL) 3Q Update p.12
Aries Capital Corp 3Q Update p.18
Stanley Black & Decker (SWK) EQ Update p.22
Hershey (HSY) EQ Update p.27
Colgate-Palmolive (CL) EQ Update p.33
Mondelez International (MDLZ) EQ Update p.35
Eaton Corp, (ETN) EQ Update p.40

Altria Group (MO) – 3Q18 Update

Altria tightened guidance by 1-cent following 3Q earnings. It now expects EPS in the range of $3.95-$4.03, up from $3.94-$4.03. The stock is 16x EPS with all the recent EPS growth and dividend growth due to the tax cut of 2017 – not from operations. The 5% yield is attractive to many, but as we have discussed in reports on June 14 and June 21, we still question how sustainable it is. The company targets an 80% payout of earnings. Given low capital spending that does not sound too high. However, free cash flow seldom equals earnings and we see several potential hits to the business including: continued volume decay, higher excise taxes and price hikes driving volume down further, FDA banning menthol, lowering nicotine levels, and implementing graphic packaging so cigarette packs show people with health issues.

We believe the company is very well managed and it can withstand a few pennies +/- in EPS changes without difficulty. However, many of these larger issues are game changers for MO and the dividend in our view. MO does not have another income tax cut coming for cash flow and earnings growth. Philip Morris has already shown that the heated tobacco market can quickly replace a large swath of the traditional smoking market and generate incremental sales related to the heating device. It also has shown in Japan and Korea that within a year, competition cuts pricing and the revenue produced by stocking the channel does not repeat.

- Smoking results are flat, helped by pricing, but MO is still losing market share and pricing is no longer offsetting volume declines

- 3Q cash flow benefited from timing of settlement payments and working capital changes

- Loss of $400 million in BUD dividends and falling cash from the leasing business PMCC are going to make a dent in the cash flow cushion as will IQOS support – the forward dividend already exceeds free cash flow by our estimates

- FDA is going after menthol and other flavorings as well as pulling products with multiple actions recently – this is key because it targets prevention of youth smoking – MO agreed to support raising the federal minimum age to 21 to buy any tobacco product

- FDA is accelerating its mandates for graphic packaging on cigarettes under court order

- FDA gave a presentation on October 11 highlighting the positives to cutting nicotine levels in cigarettes dramatically – focusing on more people quitting and fewer starting

- It seems unlikely MO will have heated tobacco to itself and studies show it does not stop the decay of smoking. It may add some extra costs that offset MO's efforts to cut expenses as smoking volumes decline

Lack of Growth Continues to Accelerate

We still look at MO as a smoking story as that is over 85% of the income. It simply isn't growing and 3Q and YTD has not changed that. The rate of decline for the industry and MO continues to accelerate:

Cig. Vol.	YTD 18	2017	2016	2015	2014
US Market	-4.5%	-4.4%	-2.4%	0.1%	-3.4%
Altria	-6.3%	-5.1%	-2.5%	0.5%	-3.0%
Marlboro	-5.8%	-5.0%	-2.6%	0.0%	-3.1%

Distributors tend to buy ahead of price increases and excise tax increases. In early 2017, California raised the excise tax by $2 per pack, which hurt 2017 results vs. 2016. However, 2018 has not bounced back. Also, MO raised prices in September 2018, which also led to more buying ahead of that in the quarter. The 2018 YTD figures adjust for that.

In good years, MO has operating income growth from smoking products. That can be impacted by charges to streamline the business, litigation payments, and adjustments to master settlement deals. That speaks well to MO's prowess at cutting costs as volume falls as well as the power of price increases that drop to the operating income line with very little incremental expense. However, we believe MO has reached the tipping point where pricing is not offsetting volume loss:

MO Smoke Revenue	YTD 18	2017	2016	2015	2014
Pricing	$829	$1,058	$636	$720	$795
Volume	-$1,188	-$1,273	-$577	$133	-$724

Adjusted operating income, which excludes restructuring charges and litigation issues is not growing any longer either. 2017 saw a one-time pop in growth with a $288 million cut in marketing and administrative costs, but those are rising again:

MO Smoke Income	YTD 18	2017	2016	2015	2014
Adj. Op Inc	$6,462	$8,561	$8,002	$7,599	$6,851
Growth	-1.6%	7.0%*	5.3%	10.9%	6.7%

- 2017 growth would be 3.4% adjusted for cut in marketing and admin.

Without earnings growth in this area, it becomes more difficult to boost dividends and continue share repurchases.

Cash Flow Benefits and Headwinds

While MO talks in terms of the dividend payout of 80% vs. EPS, we prefer to look at the situation from a cash flow standpoint. We pointed out the basic issue in the June report – Cash from operations is normally under $5 billion, capital spending about $200 million, and the dividend about $4.8 billion and growing.

The tax reform will add about $1.0-$1.1 billion to cash flow. That's a big positive for MO. Of that money, MO is ear-marking one-third for new products/investments and the rest for shareholders. That leaves a $700 million cushion for the dividend situation. Here are other issues to consider:

- Anheuser Busch Inbev cut its dividend in half last week. That dividend gives MO about $800 million of its cash flow per year, and going forward, $400 million is gone.
- PMCC's portfolio is in run-off and contribution to cash has been declining.

PMCC Cash	YTD 18	2017	2016	2015	2014
Cash in	$0	$133	$231	$354	$369

- Free Cash Flow has already benefitted from falling capital spending, which is expected to be $200-$250 million in 2018. It is also common for MO to make some acquisitions:

MO spending	YTD 18	2017	2016	2015	2014
Cap Exp	$132	$199	$189	$229	$163
Acquisitions	$0	$415	$45	$0	$102

- The $0.80 quarterly dividend already annualizes out to $5.38 billion, up $569 million from what was spent in 2017.
- Share repurchases have mitigated the full impact of dividend per share growth, but it is unlikely MO can afford to keep buying shares at past rates.

MO spending	YTD 18	2017	2016	2015	2014
Dividend/Share	$2.86	$2.54	$2.35	$2.17	$2.00
Growth/Share	14.9%	8.1%	8.3%	8.5%	8.7%
Total Dividend	$3,909	$4,807	$4,512	$4,179	$3,892
Total Growth	10.3%	6.5%	8.0%	7.4%	7.8%
Share Repurchases	$1,317	$2,917	$1,030	$544	$939

- Don't cheer the $2.4 billion positive move in cash flow for YTD 2018. Much of that is the remaining benefit of taxes that will lap in 2019 ($440 million), higher settlement charges that are negatively impacting earnings but are accrued and MO will have to pay them ($1.1 billion), and working capital changes of $270 million. Also, of the $300-$350 million from the $1.0-$1.1 billion in tax savings estimated to be spent on new products this year – much of that was not spent yet. That's the bulk of improved cash flow and it does not appear sustainable.

So here is cash flow for the last several years before the tax reform.

	2017	2016	2015	2014	2013
CFO	$4,922	$3,821	$5,843	$4,663	$4,375

Be generous and call it $5 billion per year. Going forward, add in $1.0 billion for the lower tax rate and subtract $400 million for the reduced BUD dividend and subtract $300 million in product investment spurred by the tax cuts. That leaves MO with $5.3 million on average in cash from operations. Pay out $200 million in capital spending and the Free Cash Flow is $5.1 billion.

The $5.1 billion in Free Cash Flow does not have much cushion from PMCC at this point. A smoking division with no growth or negative growth is going to be a headwind on that Free Cash Flow too. From that $5.1 billion, MO has to pay a dividend of over $5.3 billion and repurchase shares. That also assumes no increase in litigation costs or settlements and no acquisitions.

The Frog Is in Hot Water Already

One of the points that always makes us chuckle is the bullish view on Altria that says, "Hey the Government is being very benign here." As we noted in the June 14 and June 21 reports,

between excise taxes, healthcare settlements, and income taxes – governments take 42% of Altria's revenue off the top and another 21%+ of its income.

The same is said about the FDA, which has regulated tobacco sales, marketing, use, and along with state and local governments banned people from smoking almost everywhere in public. Too few people do not look back and see that 481 billion cigarettes were sold in the US during 1995 (hardly the days of the chain-smoking Rat Pack) and in 2015 the volume was 247 billion and falling faster since. The view of the bulls remains, "Oh any FDA action won't happen for many many years."

We will update some of the recent actions from just the last couple of months in the rest of this report. It is important to remember that even shrinking cigarette volumes are kept at higher levels by new smokers starting. 95% of smokers start before age 21. Also, menthol cigarettes have been the only area of smoking showing flat to higher smoking rates. If something disrupts the path that creates new smokers – the drop in smoking volumes could accelerate much more.

FDA Is Cracking Down on Youth Gateways, Flavors, and Menthol Now

We noted in June that the FDA was disturbed with how many kids were vaping and using e-cigarettes. It did not want young people getting addicted to nicotine and then becoming smokers. Far from taking years to act, the FDA is cracking down in September and October.

What makes the news is the investigation into JUUL and many of its flavored e-cigarette products. However, in September the FDA cracked down on Reynolds for its Camel Crush Bold – which has a menthol capsule in the filter that can be used to give menthol flavoring to a regular cigarette. According to Matt Myers the President of the Campaign for Tobacco-Free Kids, the capsule delivered menthol at higher levels than other menthol cigarettes and added sugars and sweeteners. The FDA is prohibiting the sale of Camel Crush Bold. The FDA also had Reynolds pull Deep Set Recessed Filter cigarettes in regular and menthol varieties and Vantage Tech 13.

The FDA approached Altria in September as well and in October, MO pulled products off the market too. These include MarkTen Elite and Apex pod-based products. Also, all cig-a-like products in any other flavors besides tobacco, menthol or mint flavors. That will result in 20% of MO's e-vapor products being removed the market. MO actually provided

data to the FDA showing that adult non-smokers did not find the flavors appealing – further highlighting that removing them should help prevent young smokers from starting.

That sounds like a small hit overall, but it's rare that the FDA has pulled products from the major players off the market. It is specifically targeting ways that enable the young to get gateways to smoking which means making early smoking experiences more pleasant with flavors and menthol.

Perhaps, most important – MO has now agreed to support the FDA in pushing for federal legislation to make 21 the minimum age to purchase any tobacco product. That would include snuff, heated tobacco, as well as regular cigarettes. Remember, 95% of smokers start before age 21. If the volume of cigarettes is declining at 4% now, it probably means that it is really falling at 6%-7% with 2%-3% growth from new smokers. So, the decay rate could accelerate very quickly with this type of push. We would also ask; what politician would ever vote "No" on this? This may be quick moving legislation.

As far as the overall consideration to ban menthol – the FDA is gathering comments and started this process in March 2018. The EU is already imposing a ban in 2020. Canada banned menthol in 2017. Various health organizations and the FDA do not see menthol as an addictive substance. However, they do view it as a way to mask the harshness of tobacco smoking and allow smokers to inhale deeper, smoke more often, and more easily pick up the nicotine addiction. The FDA's goal is to reduce the number of people smoking and even though all forms of cigarettes are declining, menthol brands are showing the strongest resiliency and even posting positive growth in some years. With Camel Crush Bold and Pall Mall's Deep Recessed Filter, they have now pulled some menthol cigarettes off the market. Also, the trend is toward bans – other countries beyond the EU and Canada have adopted them. Oakland banned menthol in 2017, San Francisco banned it in June, New Jersey is working to ban this year too.

We think the FDA is moving more quickly than others believe to stop young people from smoking, vaping, dipping, or any other form of nicotine/tobacco use. Given the usage stats on menthol, its appeal to youth and helping people start smoking, and the growing number of bans – the FDA may take some negative action here much quicker than others think. Moreover, it doesn't have to be a sweeping ban to impact the market. A 21-and-over age limit would be a small step and would do considerable damage to cigarette volumes and all other forms of tobacco. Other smaller steps could be more specific product bans, continued delays in approving heated tobacco products like IQOS, or graphic packaging.

Court Orders FDA to Speed-Up Graphic Packaging in September

Graphic packaging on cigarettes involves showing pictures of people with black or no teeth, late-stage cancer, and other ill-effects of smoking. This also targets youth smoking prevention as well as pushes current smokers more toward stopping. Over 120 countries have already adopted this and seen strong results in reducing cigarette purchases. The results are driven by changing the photos on the package so people do not become immune to them. Also, cigarettes are one of the few packages that people carry around all the time. If you eat a cheeseburger, you throw the wrapper away in probably a minute. But, a pack of cigarettes contains 20 so the pack is on display often and regular smokers nearly always have a pack and look at the pack often. Kids and other non-smokers see the packs more often too with the photos.

A 2013 study by Johns Hopkins looked at the effectiveness of graphic warnings and found that they are effective in lowering smoking rates along many paths. Young and adult non-smokers are deterred from trying cigarettes more often in places with graphic warnings. It increases knowledge among the population on the harmful effects of smoking. Smokers who quit already are unlikely to relapse back to smoking again. Current smokers are more likely to skip having a cigarette when seeing the package. Current smokers are also more likely to boost efforts to quit. This again could cut volumes at MO in 3 ways: More smokers quit, more current smokers cut their consumption level, fewer non-smokers start. This is not a far-away problem for MO and cigarette volumes.

Congress asked for an FDA plan in 2009. In September a federal judge gave the FDA three-weeks to come up with a plan and they filed one in October. The FDA is planning to complete its study in the spring of 2019 and have a final rule in the federal register by May 2021. The judge has been very displeased with the multi-year delay already and said in the ruling that the FDA has already "unreasonably delayed" the enactment of this policy. Any changes he may enforce are likely to cut the time for the final rule to sometime earlier than May 2021.

Cutting Nicotine Levels in Cigarettes is also Moving Forward at the FDA

We wrote about this plan extensively in June. A quick summary is that cutting nicotine levels in cigarettes is possible and when it has been tested, people quit smoking. This is helped by the acknowledgement that 2/3 of smokers want to quit. The research shows of 30

million adult smokers in the US – 5 million could quit in the first year if nicotine levels are reduced. That could rise to 13 million over 5-years. That is 16%-40% of the US cigarette market. In our June 21 report, we estimated that these forecasts could cut MO's cash flow by $1.0-$1.5 billion in the first year and rise after that if low nicotine standards are adopted.

The head of the FDA has addressed this issue as very promising in his goal of recognizing smoking cigarettes as the most harmful way to deliver nicotine and therefore he wants to reduce the amount of smoking. This also works to help kids not become addicted – giving this the potential to cut current smokers and reduce the number of new smokers.

Dr. Lynn Hull, the lead pharmacologist at the FDA held an hour-long webinar on October 11, 2018 to discuss the science and effectiveness behind Very Low Nicotine Content. VLNC cigarettes have 0.2-0.7mg of nicotine vs. 7.2-13.4mg for regular cigarettes. She highlighted noted a number of studies and the findings. Keys are that it cuts the number of cigarettes smoked per day, does not change how cigarettes are smoked (no deeper inhales or more puffs per cigarette), reduces addiction, may increase attempts to quit, and there was no evidence that it increases cravings or withdrawal symptoms. It also made it less likely that non-smokers would become addicted if they experiment with VLNC cigarettes.

IQOS from Philip Morris Could Give MO a Short-Lived Bump

Altria hopes to get approval from the FDA to roll-out heated tobacco products soon. This involves a device that users load with replacement sticks that are sold similar to a pack of cigarettes. Philip Morris saw rapid adoption when it rolled out this product in Japan and Korea. We do believe that this could give MO a bump because it would stock the inventory channels with devices that cost more than a pack of cigarettes and the replacement packs.

Many smokers may be willing to try them, and the excise tax situation may be more favorable in the early days. Some excise taxes are based on amount of tobacco weight and heated tobacco has less than regular cigarettes. Because heated tobacco packs would replace regular packs of cigarettes – we believe the federal, state, and local governments would move quickly to adjust the tax situations.

There are several downsides to heated tobacco for Altria. First, it further crushes the sale of regular cigarettes, as smokers switch. Second, heated tobacco delivers less nicotine, which could help people quit altogether. It is not at the VLNC level, but if lower nicotine

makes people start to smoke less and quit – that may hold true here too. The data we have seen shows that even the tobacco companies believe heated tobacco does not stop the long-term decay rate of smoking overall. Instead, they believe that smokers who do not quit may live longer (due to less exposure to toxins in smoke) and thus continue as customers for more years. Third, a big rollout will likely come with higher marketing and support spending and thus could happen at a lower margin than regular smoking – MO has maintained earnings with consistent cost cutting. Fourth, the FDA has made it very clear that it does not want a bunch of young people addicted to nicotine, which is why it is cracking down on flavors with e-cigarettes and calling for a minimum age of 21 to buy any form of tobacco. That could limit the market for heated tobacco and keep pressure on to restrict young non-smokers from starting.

We have written about this in various reports on Philip Morris. What PM found was fast growth that stalled after a year in Japan and Korea. PM found competitors quickly rolled out competing devices and took back market share with price cutting. The primary competitor for MO is British American Tobacco who bought Reynolds – BAT already has a heated tobacco product too in foreign markets. We think MO is unlikely to have the same first to market advantage that PM enjoyed in Japan. PM has the benefit of rolling out heated tobacco in many more countries in the future to show new areas of initial stocking growth. MO only has the US, thus will only get one roll-out.

Conclusion:

Altria has enough cash and borrowing ability to maintain its dividend even though free cash flow no longer does. However, that won't last forever as smoking rates continue to erode. MO is also losing volumes faster than the industry and its price increases are no longer offsetting the impact of volume decay. That's the current situation.

We see several reasons to expect the decay rate to accelerate – especially with MO now supporting the FDA's efforts to raise the minimum age to buy any tobacco product to 21. If 95% of smokers start before age 21, this has the potential to cut the number of new smokers to replace those who quit or die and accelerate the decay. The FDA has already started pulling products and flavorings that make it easier for young people to take up smoking via e-cigarettes and ways to mask the harshness of tobacco. That includes pulling menthol related product. The FDA is now accelerating the roll-out of graphic warnings on packaging and is continuing to tout cutting nicotine levels in cigarettes as a way to reduce smoking.

Both of those have proven effective in cutting cigarette volumes. Many countries have menthol bans with the EU's starting in 2020 and the FDA is looking at that too. As the one area of the smoking market that has seen some resiliency – restrictions on menthol would also cut volumes quickly. Canada showed double-digit drops after the ban.

If the decay rate continues to accelerate as it has for three years at this point, we think the dividend comes under pressure as these new FDA policies gain more traction. Much of this doesn't even require a full-out ban of the product. Age limits and graphic packaging wouldn't change the content of cigarettes at all. Allowing other manufacturers to release lower nicotine cigarettes may win over some current smokers and help them quit without outright banning higher nicotine cigarettes in the early stages.

A roll-out of heated tobacco has the potential to give MO a bump for a year or maybe two. However, we believe this roll-out will cost more to market than current cigarettes and will not create new smokers. Its major competitor also has heated tobacco products so first-mover advantages are unlikely to last. Moreover, the FDA will not want young non-smokers picking up the habit via heated tobacco. All the signs are there that the decay rate will remain in place for smoking volumes after a year of stocking the channel.

Welltower (WELL)- 3Q18 Update

As the company reported 3Q earnings, the WSJ ran an article on October 30 that highlighted the macro-problem Welltower has been experiencing. Supply continues to rise to meet the needs of aging baby-boomers. However, most people do not move in until they reach at least 82-years old, and the oldest baby-boomers don't hit that age until 2028. In the meantime, occupancy rates remain near historic lows, people find other ways to live with/near family members, and rents are appearing too high for many seniors.

WELL beat FFO forecasts by 2-cents per share, but came in 4-cents below last year. It raised guidance for 2018 from $3.99-$4.06 to $4.02-$4.07. We are not impressed. The company is moving more of its triple-net lease units into RIDEA structures and the Seniors Housing division. Triple-net involves much less risk to WELL as the operator pays all the operating costs and repairs/maintenance. Under the RIDEA structure, WELL gets paid a larger percentage of revenue but is responsible for the operating costs which nets down to an income figure used to calculate FFO. However, FFO does NOT subtract capital spending. So, there is an apples-to-oranges comparison going on here. Adjusting for that, investors are paying nearly 20x cash flow for almost zero growth and a flat dividend.

WELL is moving units from the lower margin Triple-Net Lease unit to higher-margin Seniors Housing. That alone should be boosting FFO rapidly and it's not. However, if we adjust for the fact that WELL is also now paying more in capital spending, Free FFO (think of this as free cash flow) is not growing much. FFO for the 9 months ending September 2018 rose 4-cents, Free FFO rose by only 1-cent. Even worse, for the 3 months ended September 2018, FFO fell by 4-cents and the company cut capital spending so that Free FFO fell only 2-cents per share. That FFO is not increasing faster is a red flag for us.

- Moving Units to Seniors Housing is crushing income growth in that division. That is evidence that the units being added are troubled properties.

- FFO is not a good measure anymore. WELL is now responsible for capital spending at existing properties as a result of converting properties away from Triple-Net.

- Occupancies remain weak at all divisions.

- Strong properties do not convert away from Triple-Net. WELL pointing out improvements in Triple-Net after culling 25% of the properties does not impress us as they concentrate the good tenants in recent results.

Seniors Housing Income Growth Is Falling Rapidly

For several quarters, WELL has been restructuring the portfolio. Triple net lease properties have been declining as the company sells assets to unconsolidated entities, third parties, or changes their structure and moves them into the Seniors Housing unit.

	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
Triple-Net Units	341	404	405	426	422	432
Seniors Housing Units	587	518	514	504	501	488

The company is focusing investors on Funds from Operation – FFO. FFO is essentially net income plus depreciation and adjustments for any one-time items such as gains, losses, impairments. In the case of Triple Net leases, WELL has a stable rent income with essentially no operating costs. The customer covers all maintenance, taxes, insurance, and operating costs. In Seniors Housing, WELL takes on more exposure to these costs and the payments received are tied to the profitability of the property. In the case of a RIDEA structure, WELL takes on more exposure to the costs and the actual underlying economics of the property and it has more direct control in the situation. In non-RIDEA, WELL hires a third party to be the sole operator.

Because there are fewer capital payments owed by WELL and the operator assumes 100% of the operating risk, Triple Net income is lower than Seniors Housing Income.

($ 000's)	3Q18	3Q17
Profit/Triple Net Unit	$312.6	$330.6
Profit/Seniors Unit	$478.0	$467.9

This is simply the same-store operating income for each unit divided by the number of units for 3Q18 and 3Q17. As operating income goes, WELL makes $140,000-$160,000 more per unit with Seniors Housing than a Triple-Net unit. There are other variables to this such as number of beds, location, and age of each unit. The composition of the portfolio changes too, so don't treat the difference in reported income as something easily extrapolated over time.

We just wanted to show that income is higher by design at Seniors vs. Triple-Net. However, the basic fact is because more risks are assumed, the operating profit for Seniors Housing should be lumpier but should also be higher than Triple-Net leasing as there are more capital costs involved.

We're supposed to cheer that FFO is barely rising 1.5% (4-cents) over the last 9-months and it actually fell by 4-cents in the 3Q18? The company has cut the lower profit Triple-Net portfolio by 81 units and grew the higher profit Seniors unit by 86 units in the last year. Shouldn't FFO be exploding upwards given that the higher income unit is growing? Instead Same-Store Operating Income growth at Seniors Housing is vanishing:

	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
SSS NOI growth	0.3%	0.1%	0.6%	1.5%	4.1%	3.5%
Units in SSS	470	435	461	441	423	422

As the unit has grown and the early transfers started to show up in the same-store y/y comps – the income growth figure has collapsed. Don't forget the table above, there are 587 units in Seniors now, only 470 were in the comp in 3Q so this has a long way to go before it fully reflects the situation in our view.

Investors Need to Subtract Maintenance Spending from FFO

When WELL was essentially all Triple-Net leasing, FFO was a reasonable metric to use in reviewing results. The tenant was responsible for all the repairs, improvements, and maintenance spending. So FFO per unit was lower, but there wasn't capital spending.

Now that WELL is doing so much more in Seniors Housing, it is responsible for more capital spending needs. We would expect to see the spending increase as well.

($ 000's)	3Q18	2Q18	1Q18	3Q17	2Q17	1Q17
FFO	285.3	378.7	353.2	295.7	384.4	306.2
Maint Cap Ex	62.3	64.8	46.5	66.0	51.0	42.1
Net FFO	223.0	313.9	306.7	229.7	333.4	264.1
FFO/Share	$0.76	$1.02	$0.95	$0.80	$1.04	$0.84
Net/FFO/Share	$0.60	$0.84	$0.82	$0.62	$0.91	$0.72

Not only is FFO declining for the last two quarters, but capital spending looks very low given that the number of units in Seniors has been rising. Also, the age of the units has been increasing and now averages 17 years. Let's also remember what some of these units are. WELL restructured leases with the tenant and then converted the structure. That happened because the tenant was in financial trouble and the lease was onerous. Quick question, "Do you think that tenant was doing all the maintenance spending needed in recent years?"

We think FFO will continue to be pressured by income weakness at the Seniors division where 20% of the units are still not part of the comp. We also believe capital spending will need to rise at those units, which reduces net FFO and gives a more apples-to-apples comparison or results now with those in the past.

Even with the reduced capital spending – the company is likely trading at about 19.5x Net FFO instead of 16.5x reported FFO.

Occupancy Continues to Weaken

As we have been writing in our discussions of Welltower and the WSJ article we linked to at the top of this update, occupancies are not rising for Senior Housing. This is the result of too much supply and fewer people moving in. We still think the other problem is the average stay is very short – under three years. With that much churn, Welltower properties have to sign up a huge number of new residents just to post flat results.

We agree with the WSJ sources that this is a problem for the next decade not a quarter or two – there is too much supply. Welltower's occupancies continue to show this as well:

Occupancy	3Q18	2Q18	1Q18	4Q17	4Q16	4Q15
Senior Triple-Net	86.2%	86.2%	987.7%	87.6%	89.2%	89.0%
Seniors Housing	88.2%	87.6%	87.6%	88.4%	90.7%	91.6%
LT Post-Acute	81.4%	82.7%	82.6%	82.4%	81.5%	85.7%
Out Patient	93.4%	93.6%	94.0%	93.8%	95.0%	95.1%

This is why WELL restructured leases and traded properties around. The story remains that there are lease escalators built in to provide growth, but as we've been pointing out –

many of these contracts have had rents cut or waived by WELL, reset at lower levels and then set to increase again.

Welltower Touts Improvement in Triple-Net

Triple-NET SSS	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
Op. Income Growth	4.2%	3.1%	3.0%	2.8%	3.0%	3.0%
Number Units	290	305	349	344	368	389

The company wants to say that the Triple-Net business has turned around. We completely disagree. It has culled out problem units and concentrated results around the remaining ones. The number of units is down 25% in how they measure same-store growth. The problem cases have been moved to the Seniors unit as described above.

Operating a senior living home involves rent, utilities, food, labor, taxes, insurance, etc. Many of those are largely fixed costs and do not change much based on having 200 residents or 250. However, the costs also do not change much if only 150 residents are there. However, revenue is a variable item dependent on the number of people living in the place. Thus, the marginal residents determine whether the business is viable or not.

If your place is full, you are making solid profits. There is no reason to cut WELL in on that deal. You're more than happy to pay them their low fixed rent with a 2% escalator and assume the risk of other costs. If your place has lots of empty rooms, and you need to modernize the place to attract more residents, you likely already cannot pay all your bills including rent. You're more than happy to restructure the deal and let WELL share the operating risks, pay some of the bills, lower the rent, and share any potential upside if the property occupancy improves in a big way.

That is why the Triple-Net growth looks better – the operators left are making money. But, Triple-Net is a much smaller part of the Welltower operation. If the operators were losing money and needed a partner with capital – they would be moving to a new deal. It is important to remember that many of the operators that are being replaced or taking new RIDEA deals like this are not inexperienced. Many have decades of experience operating dozens or even hundreds of properties. They are just running into a glut of oversupply in the industry.

Considering the overall change in Seniors Housing, capital spending, and Triple-Net in total – we are not convinced WELL's result results are that strong.

Ares Capital Corp (ARCC) -3Q18 Update

ARCC beat forecasts by 5-cents per share in the quarter. Much of this was due to rising interest rates. The company's earnings are sensitive to LIBOR, with every 100bp of increase adding about 17-cents to EPS per year or just over 4-cents per quarter. The cushion on the new increased dividend has improved:

	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
Core EPS	$0.45	$0.39	$0.39	$0.38	$0.36	$0.34
Dividend	$0.39	$0.38	$0.38	$0.38	$0.38	$0.38

While EPS may be lumpy and not grow in every quarter, we did not see any new problems with the quarter and think the long-term potential is still here. The large cash balance coming out of the quarter due to exiting a large investment in 3Q may be small a 4Q headwind depending on how quickly the excess cash can be deployed as it earns very little compared to a traditional debt or equity deal for ARCC. We think the dividend has much further to rise as ARCC grows its portfolio and boosts its income. Under the tax rules for a BDC – it needs to distribute at least 90% of its income so higher income should mean rising dividends. We still see this company as undervalued with a solid growth plan based four key points:

- Maintaining a positive bias for earnings to grow if interest rates increase.
- Boosting Debt/Equity from the current 0.54x to 0.9-1.25x over the coming years without raising new capital. That should also boost EPS.
- Focusing on growing investments and yield-producing investments, while maintaining safety. Investing in growth may create more opportunities to invest further.
- Capitalizing on its sheer size of being the largest player in the BDC sector and experience with customers to avoid the brunt of competitive pressure.

Bulk of the ARCC's Portfolio is Floating Rate

After 3Q18, ARCC noted that the total portfolio is 83% floating rate, 6% fixed, and 11% equity. It added $1.9 billion new investments with 97% being floating and exited $1.9 billion

in investments where 80% were floating rate. Also, the bulk of the floating rate loans have interest rate floors as well.

CEO Kipp DeVeer called this portfolio design as a key for 3Q earnings growth:

> *"Our core earnings were $0.45 per share, a 25% increase over the same period a year ago. The improved earnings were driven by higher total portfolio yields as* ***we benefited from continued increases in LIBOR*** *and stronger fee income."*

CFO Penni Roll confirmed that earnings will see solid gains if rates continue to rise:

> *"For example, using our balance sheet at September 30 and assuming* ***a 100 basis point further increase in LIBOR, our annual GAAP earnings are positioned to increase by up to approximately $0.17 per share."***

Debt to Equity Ratio Is Expected to Grow

In our August 16, 2018 report on ARCC, we modeled that boosting the company's portfolio by $500 million adds about 1.0-1.5 cents per quarter to EPS (4-6 cents annually based on the interest spread realized between 5%-8%). That assumes each $500 million is done 100% with debt. Investing $500 million in cash without debt should be a larger source of EPS growth.

The company wants to add leverage to the portfolio over the next three years. Currently, the debt/equity ratio net of $0.8 billion in cash is only 0.54x. The goal is to reach 0.90x-1.25x with more leverage without raising new equity.

With equity at $7.3 billion, ARCC could put $0.5 billion of cash to work and add another $1.0 in debt to boost the portfolio by $1.5 billion and the debt/equity ratio net of $0.3 billion in cash would still only be 0.75x. However, $1.5 billion adds 12-18 cents per share annually.

This plan will be lumpy as new commitments are netted against returned capital. Historically, ARCC only closes about 4% of deals it looks at in any given year. Also, in recent years the acquisition of American Capital resulted in ARCC selling many of those acquired assets that came with low or no yield and redeploying the capital. In the 3Q, ARCC realized a large investment that resulted in a $324 million gain. It also helped drive total realizations to $1.9 billion.

	3Q18	2Q18	1Q18	4Q17	3Q17
New Commitments	$1,924	$1,619	$1,792	$1,506	$1,546
Exit Commitments	$1,914	$2,200	$1,342	$1,321	$1,644
Net Debt/Equity	0.54	0.57	0.69	0.66	0.64

There is probably one more quarter before this Net Debt/Equity starts to rise noticeably again. ARCC noted that it probably has about $350 million of non-core assets from the American Capital deal it would like to move out of the portfolio and redeploy the assets. From October 1-24, it made $412 million in new deals and exited another $389 million. The CEO also guided that they would need to have a backloaded 4Q as with the holidays not much usually closes after mid-December.

After 4Q18, we expect the ratio to increase as repositioning the American Capital assets ends. Also, ARCC finished amending their bank facility documents to operate with lower total assets to debt ratios which allows ARCC to take advantage of the new higher leverage rules allowed for BDCs. The backlog of investments is $1.46 billion as of October 24.

We also take comfort that much of the reason the net debt to equity ratio is so low is the cash balance is abnormally high at $800 million following some exit realizations in the quarter. Cash is a drag on earnings as it earns very little and gives ARCC a huge incentive to put it back to work. Simply putting $500 million in cash back to work would add to EPS and only move the ratio back to 0.61x. Also, the ratio was 0.69x only a few quarters ago, so getting above 0.7x does not look unrealistic to us for early 2019.

The other reason we are optimistic is ARCC is several times bigger than all the other publicly traded BDCs. They also have more experience and know many more companies well than most of the competitors that started up after 2009. This allows them to look for larger deals and there is less competition in that area, so they are more likely to win the business. According to the CEO:

> ***"In today's competitive market, we're able to differentiate ourselves from the competition by writing large-scale commitments and delivering certainty with our significant final hold capabilities. We also utilize our long-standing relationship to take advantage of our sizable portfolio of incumbent borrowers. And finally, the flexibility of our capital remains a tremendous advantage. We continue to remain very selective on new deals, as evidenced by the fact that we closed just 3% of the transactions that we reviewed for new companies in the third quarter, just running below our average close rate since 2010 of just over 4%.***

And it's an indication that we're being even more selective in today's environment. We also continue to invest in larger companies as our capital base provides us opportunity to be relevant with larger middle market borrowers. The weighted average EBITDA of third quarter new commitments was over $100 million, which demonstrates how our size allows us to grow with our best borrowers and to be meaningful to larger, more established companies in transactions where we find compelling risk-adjusted returns."

We Are Not Seeing Erosion in Portfolio Quality

	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
Avg EBITDA	$92.9	$82.4	$76.5	$62.2	$65.9	$70.1
LTM EBITDA Growth	6%	7%	7%	6%	4%	5%
1st Lien Sr. Secured	44%	40%	42%	44%	41%	25%
2nd Lien Sr Secured	30%	30%	30%	32%	35%	33%

The portfolio is not only generating more income with higher yields, the companies are also seeing solid growth with y/y EBITDA gains of 6%-7%. The companies are getting larger as shown in the move from the low $60 million in EBITDA to over $90 million. And, ARCC is getting a higher percentage of 1st Lien Senior Secured loans. The company was specifically asked if there is any deterioration in loan terms – is it a borrower's market. The CEO noted that smaller loans where there is more competition, that is more likely to happen. However, with its focus on larger deals and experience with the borrowers that has not been an issue. Nonaccrual loans have been flat for several quarters at 2.7% of the portfolio.

Stanley Black & Decker (SWK) 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 maintaining our 4- (Acceptable) rating on Stanley Black & Decker (SWK).

SWK reported adjusted EPS of $2.08 in the 9/18 quarter which beat the consensus targets by 4 cps. However, revenue was a slight miss largely owing to negative currency. The company lowered its guidance for the full year by $0.25 per share due to tariffs, rising commodity costs, currency impacts and lower than expected organic growth partially offset by lower tax rate and other "below the line" items.

- Inventory DSIs continues to rise, jumping almost 10 days over the 9/17 quarter. The company contends that this is in preparation for the massive rollout of new Craftsman products. The fact that the buildup was across all inventory components and not concentrated in finished goods lends credibility to this and reduces our concern.

- Accounts receivable days (DSO) rose by a little over 2 days in the quarter which the company attributed to higher core growth. We are not especially concerned with the increase in receivables but it is an item to be watching in the next quarter.

- Management announced it will be taking $125 million in charges related to a plan to reduce costs by $250 million to combat tariff, commodity and FX headwinds.

Inventory Up

SWK's increase in inventory days of sale (DSI) accelerated noticeably in the 9/18 quarter. DSIs now stand at a recent historical high:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Cost of Sales	$2,262	$2,361	$2,050	$2,055
Inventory	$2,650	$2,444	$2,350	$2,018
DSI	106.9	94.5	104.6	89.6

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Cost of Sales	$2,112	$2,079	$1,799	$1,850
Inventory	$2,247	$2,078	$1,977	$1,478
DSI	97.1	91.2	100.3	72.9

However, as we have noted before, there does not appear to be a disproportionate increase in finished goods inventory typically associated with an unintended buildup in product, as shown in the following table:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Finished Goods % of inventory	72.6%	71.0%	72.1%	72.4%
In-Progress % of inventory	7.4%	8.1%	7.5%	7.7%
Raw Materials % of inventory	20.0%	21.0%	20.4%	19.9%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Finished Goods % of inventory	73.3%	72.3%	73.6%	70.6%
In-Progress % of inventory	7.4%	8.0%	8.0%	9.0%
Raw Materials % of inventory	19.3%	19.7%	18.3%	20.3%

Finished goods actually fell as a percentage of total inventory. This adds credibility to the company's explanation that it will be carrying more inventory to support the upcoming launch of new *Craftsman* tools. Consider this quote from the 9/18 quarter conference call:

> *"We are, however, revising our outlook to deliver a free cash flow conversion rate of approximately 90%.* ***This recognizes our expectation to carry higher inventory due to continued growth in the business and the ongoing Craftsman rollout****"*

SWK has plans to release more than 1,200 new *Craftsman* products over the next year including hand tools and lawn and garden equipment to be sold through major retailers including Lowe's and Amazon. This reduces the concern of the inventory spike.

In addition, we note that accounts payable days increased by about three days above the year-ago quarter, but this is to be expected given the ramp-up in inventories.

Receivables Up

As the following table shows, accounts receivables days of sale (DSO) at the end of the 9/18 quarter climbed by about two days over the year-ago quarter. Note that previous periods have been adjusted for the derecognition of accounts receivable sold under the company's discontinued securitization program.

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Sales	$3,494.8	$3,643.6	$3,209.3	$3,305.6
Net Trade Accounts Receivable (balance sheet)	$2,236.2	$2,151.4	$1,986.1	$1,628.7
Securitized Receivables Derecognized	$0.0	$0.0	$0.0	$100.8
Adjusted Receivables	$2,236.2	$2,151.4	$1,986.1	$1,729.5
Adjusted DSOs	58.4	53.9	56.5	47.7

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Sales	$3,359.4	$3,286.7	$2,856.3	$2,920.4
Net Trade Accounts Receivable (balance sheet)	$2,009.8	$1,927.9	$1,728.0	$1,302.8
Securitized Receivables Derecognized	$61.0	$100.8	$65.3	$100.5
Adjusted Receivables	$2,070.8	$2,028.7	$1,793.3	$1,403.3
Adjusted DSOs	56.2	56.3	57.3	43.8

Management noted in its liquidity discussion in the 10-Q filing for the 9/18 quarter that receivables consumed more cash due to strong organic growth. Organic growth was 5% in the quarter. While this is not stellar growth, the timing of sales in the quarter could have driven the increase in receivables. In addition, the company is beginning to sell *Craftsman* into new channels we speculate could distort the timing of receivables collections. We are therefore not overly alarmed by the receivables increase, but this is certainly something to watch in the next quarter.

New Cost Reduction Program

Management announced during the conference call that it is initiating a new restructuring program due to "external headwinds, including commodity inflation, currency and tariffs, as well as a somewhat slower U.S. residential housing and automotive markets related to continued upward pressure on U.S. short-term interest rates." A charge of $125 million is expected in the 12/18 quarter and will provide for $250 million in pre-tax cost savings in 2019. There was not much detail in the call regarding the components of the charge, but management did state the following:

"On the cost reduction side, I mean, we will go through a process that we've done many times before as a company. We haven't done one of these in a while. However, the discipline in structure on the process is very much focused on, what are the types of costs that we can take out that would not impact growth initiatives within the short-term and the midterm? How do we ensure that we don't slow momentum in some of these great growth catalysts that both Jeff and Jim talked about this morning? And so it will be very much targeted to activities that are removed from the customer in that regard, removed from the innovation categories, et cetera, that really do impact growth in the timeframe of the next one to three years."

For perspective, the company has taken the following restructuring charges in the last four years which are largely related to mergers and acquisitions:

	2017	2016	2015	2014
Restructuring Charges	$51.5	$49.0	$47.6	$18.8

We certainly would not label the company as a "serial acquirer" that takes regular charges that are large percentages of profits. However, we do note that the $125 million in charges is close to what the company has spent in the last three years combined. We have an overall cynical view of restructuring charges and raise our eyebrows when a company announces it has hundreds of millions in excess costs it can eliminate without negative repercussions for operations. More importantly, we are skeptical of the quality of charge-adjusted earnings that add back all of these costs given the potential for expenses that should be viewed as ongoing being lumped into the charges.

Sears Bankruptcy Impact

It is worth noting that the company addressed the Sears bankruptcy in the conference call. SWK has only about $50 million in annual sales to Sears, so the impact of lost revenue is not material especially in light of the fact that Sears stores will effectively be removed from competition as an alternative supplier of *Craftsman* tools. SWK will continue to make its contractual payments related to its acquisition of the Craftsman brand as planned and it will continue to honor the lifetime warranty on *Craftsman* tools as planned from the beginning. SWK does have a deferred revenue liability related to a royalty-free liability which will be reversed into profits but this will be largely offset by an increase to warranty

liabilities as the company steps in to honor Sears' portion of the lifetime warranty on all *Craftsman* tools.

The Hershey Company (HSY) 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 The Hershey Company (HSY) to 4- (Acceptable)

- Accounts receivable DSOs jumped 2.5 days over the year-ago quarter. The third quarter typically sees the highest level of receivables for the year and the current level is not especially alarming when compared to 2016 and 2015 levels. Regardless, this warrants closer attention in the next quarter.

- Inventory DSIs continue to plummet as the company contends it can meet customer demand with lower inventory balances. As we noted in our previous review, the company utilizes LIFO for 60% of its inventories, but given the continued decline in spot prices for its major raw materials prices and lack of recent pricing pressure, we are yet to be concerned about a "LIFO liquidation."

- HSY has cited significant cuts to overall advertising levels despite increased spending for its core brands. In our experience, this seldom ends well for packaged goods companies.

Receivables Continue to Increase

In our review of HSY's second quarter, we highlighted a 3.2-day increase in accounts receivable days of sales (DSO) in the 6/18 quarter. However, we concluded that the size of the increase was largely due to an unusually low level of receivables in the year-ago quarter from the timing of seasonal sales. However, DSOs in the 9/18 quarter registered another 2.5-day year-over-year increase.

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Sales	$2,080	$1,752	$1,972	$1,940
Accounts Receivable	$815	$502	$614	$588
Sales YOY growth	2.3%	5.3%	4.9%	-1.6%
Accounts Receivable YOY growth	9.7%	20.2%	3.1%	1.2%
Accounts Receivable DSOs	35.8	26.1	28.4	27.7

	10/01/2017	7/02/2017	4/02/2017	12/31/2016
Sales	$2,033	$1,663	$1,880	$1,970
Accounts Receivable	$743	$417	$596	$581
Sales YOY growth	1.5%	1.5%	2.8%	3.2%
Accounts Receivable YOY growth	-2.2%	-13.7%	9.5%	-3.0%
Accounts Receivable DSOs	33.3	22.9	28.9	26.9

Management mentioned in the second quarter commentary that the receivables increase was due to the Amplify acquisition. However, we expressed skepticism that Amplify could have had a significant impact on our DSO calculation given its timing. Management offered no explanation for the receivables increase in the 9/18 quarter in either the conference call or the 10-Q. We observe that the third quarter typically has the highest DSO level of the year due to the timing of sales ahead of the key holiday season. While the 9/18 level of 35.8 is ahead of last year's 33.3, it is not materially ahead of the 34.6 and 35.4 registered in the 9/16 and 9/15 quarters, respectively. Therefore, we are still not concerned with the company's level of receivables.

Inventory Continues to Decline

HSY's inventory continues to decline, as shown in the following table:

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
COGS	$1,216	$958	$998	$1,111
Inventory	$881	$916	$782	$753
COGS YOY growth	11.5%	6.8%	2.8%	-9.6%
Inventory YOY growth	-6.1%	-2.1%	-1.6%	1.0%
Inventory DSIs	***66.1***	***87.3***	***71.5***	***61.9***

	10/01/2017	7/02/2017	4/02/2017	12/31/2016
COGS	$1,090	$897	$970	$1,228
Inventory	$938	$936	$795	$746
COGS YOY growth	-5.4%	0.8%	-4.1%	16.4%
Inventory YOY growth	11.2%	7.5%	3.2%	-0.7%
Inventory DSIs	***78.5***	***95.2***	***74.8***	***55.4***

As with the previous quarter, the decline is more centered in raw materials which implies a slowdown in production of new inventory:

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Raw Materials % of inventory	23.0%	24.6%	27.0%	24.1%
Goods in Process % of inventory	10.3%	12.7%	13.2%	10.0%
Finished Goods % of inventory	66.7%	62.8%	59.8%	65.9%
Adjustments to LIFO as % of Total FIFO	16.2%	15.6%	17.8%	19.4%

	10/01/2017	7/02/2017	4/02/2017	12/31/2016
Raw Materials % of inventory	26.2%	27.1%	30.6%	33.8%
Goods in Process % of inventory	9.1%	11.0%	11.8%	9.5%
Finished Goods % of inventory	64.7%	61.8%	57.6%	56.7%
Adjustments to LIFO as % of Total FIFO	16.2%	16.3%	18.6%	20.0%

Management noted in the 10-Q filing for the 9/18 quarter that it is purposefully drawing down inventory:

> *"This $43 million fluctuation [in working capital] was mainly due to lower investments in inventory resulting from* ***lower year-over-year build up on inventories to maintain sufficient levels to accommodate customer requirements."***

As we discussed in the last review on HSY, the company utilizes the LIFO (last-in, first-out) method of accounting for about 60% of its inventories and that investors should be alert when a company utilizing LIFO draws down inventory. The concern is that older, lower cost inventory is being matched against current sales on the income statement. Given that the company is not seeing rampant inflation in its raw materials costs and has not been increasing prices on its products, we were less concerned in our review of the second quarter that a LIFO liquidation was occurring. A company must be experiencing rising raw materials costs and increasing its prices in order to benefit which has not been the case for HSY. In the few weeks since our second quarter review, spot prices for HSY's key raw materials have continued to decline. The company also stated in the conference call that its price realization on its products has been roughly flat after adjusting out increasing promotional spend. It is also planning on starting to raise prices on products which will begin to take effect in January. At this point, the only risk we see to HSY is a sudden spike in its raw materials costs that left it vulnerable to having to replenish inventories at significantly higher prices.

The aforementioned decline in raw materials prices led to increases in mark-to-market losses in the quarter as seen in the following table.

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Net (Gains)/Losses on mark-to-market- (In COGS)	$71.088	-$0.183	-$66.590	$15.234
Net Losses Reclassified from unallocated to segment income	$23.471	$20.648	$29.660	$23.040
Unallocated (Gains)/Losses to Adjust Segment to Reported Income	$47.617	-$20.831	-$96.250	-$7.806
Cumulative (Gains)/Losses Recognized in COGS but unallocated	$58.482	$10.865	$31.696	$127.946
(Gains)/Losses Expected to Be Reclassified to Segment over 12 Months	$25.418	$41.445	$77.411	$94.449

	10/01/2017	7/02/2017	4/02/2017	12/31/2016
Net (Gains)/Losses on mark-to-market- (In COGS)	$2.445	$32.519	$5.536	$134.577
Net Losses Reclassified from unallocated to segment income	$24.399	$20.963	$22.624	$2.190
Unallocated (Gains)/Losses to Adjust Segment to Reported Income	-$21.954	$11.556	-$17.088	$132.387
Cumulative (Gains)/Losses Recognized in COGS but unallocated	$135.538	$157.492	$145.937	$0.000
(Gains)/Losses Expected to Be Reclassified to Segment over 12 Months	$93.814	$91.119	$88.675	$0.000

We showed this table in the previous review of HSY and explained that HSY records mark-to-market gains and losses in cost of sales when they occur, but only includes the impact of gains and losses related to products sold in the period in its adjusted profit figures. This amount is shown on the "Net Losses Reclassified from Unallocated to Segment Income" line. We also see that while the cumulative losses expected to be recognized in segment results over the next 12 months continues to decline which could result in a benefit to adjusted profits in upcoming periods.

Reduction in Advertising

We note that the company is reducing its overall advertising spend. Total advertising and consumer-related spending declined by 10% in the quarter with the decline in North America particularly sharp:

> *"North America advertising-related consumer marketing spend declined 18.5% in the quarter. I want to spend a couple of minutes providing some important details and context here. Media spend for our strategic scale brands was in line with prior year for the quarter. We are leveraging analytic tools to improve effectiveness of this spend to get more reach and impressions for the same amount of dollars. So far this year, we have achieved double-digit ROI increases in four of our top five brands. We are*

also focused on expanding our reach through earned media by having authentic and appropriate content in the right channels.

Our Heartwarming campaign is a great example of this. As we work through new models, we are also taking advantage of cost savings in agency and production fees, as we leverage the appropriate production for different channels. An example of this is the creation of our own in-house production studio that went live earlier this year. This is enabling us not only to take advantage of our great employee creativity, but also to be faster and more cost effective. We have also continued to right-size our investments in our smaller, emerging brands in line with our previously-stated strategy. We remain committed to supporting our portfolio and will continue to invest at levels significantly above industry average."

Our history with consumer packaged goods companies is that advertising cuts, no matter how focused and efficient, eventually result in a rebound to salvage volume growth.

Colgate-Palmolive (CL) 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 on Colgate-Palmolive (CL) to a 3- (Minor Concern).

CL's 9/18 adjusted EPS of $0.72 was in-line but its revenue came up short of estimates as its results were weighed down by both unfavorable FX and rising costs. It is interesting to note that the company has not hit a consensus revenue target since second quarter 2015 yet has recorded only one earnings miss in the same time frame.

We noted deterioration in a couple of areas in the 9/18 quarter:

- Inventory days (DSI) at the end of the 9/18 quarter jumped by 3 days over the year-ago period. Additionally, finished goods as a percentage of total inventories increased by 150 basis points over last year, a marked acceleration from the previous three quarters. These factors coupled with the lower than expected revenue in the quarter could be pointing to an unexpected buildup in product that could require discounting to move in the fourth quarter.

- Management had forecast that advertising would increase as a percentage of sales in 2018 and it has finally started happening. While absolute advertising spend declined slightly, it rose 10 bps as a percentage of sales. This drag on margins should continue as the company seeks to push through price increases, in some cases reportedly ahead of its competition.

Inventory DSIs Up 3 Days

CL's inventory days (DSI) were up by 3 days over the 9/17 quarter as shown in the table below:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$1,576	$1,585	$1,594	$1,564
Inventory	$1,245	$1,254	$1,312	$1,221
COGS YOY growth	-0.9%	3.9%	6.8%	6.1%
Inventory YOY growth	3.3%	4.6%	10.3%	4.3%
Inventory DSIs	72.1	72.2	75.1	71.2

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$1,591	$1,526	$1,493	$1,474
Inventory	$1,205	$1,199	$1,189	$1,171
COGS YOY growth	3.1%	-1.0%	-1.4%	-8.2%
Inventory YOY growth	1.0%	-2.7%	-3.6%	-0.8%
Inventory DSIs	69.1	71.7	72.7	72.5

This is the largest year over year increase seen in two years. We can also see from the table below that all of the increase was focused in finished goods:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Raw Materials % of inventory	19.9%	20.0%	19.7%	21.9%
In-Progress % of inventory	3.2%	3.6%	3.7%	3.4%
Finished Goods % of inventory	76.9%	76.4%	76.6%	74.7%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Raw Materials % of inventory	20.7%	20.1%	20.3%	22.7%
In-Progress % of inventory	3.9%	3.9%	3.7%	3.6%
Finished Goods % of inventory	75.4%	76.0%	76.0%	73.7%

Finished goods as a percentage of total inventory rose to 76.9% at the end of the 9/18 quarter from 75.4% a year ago. The finished goods percentage has been rising for several quarters, but this 150 bps increase is a marked acceleration and coincides with the spike in DSIs. The company is experiencing rising costs which could give an uplift to inventories. However, the sudden jump in DSIs and finished goods percentage increases coupled with lower than expected sales increases the concern level that there was an unintended buildup in product at the end of the 9/18 quarter. Such a buildup would increase the risk of discounting to move older product.

Advertising % Increased

CL has been saying it would increase advertising as a percentage of sales for the last couple of quarters and it finally happened. While absolute advertising declined, it rose as a percentage of sales by 10 bps. We would expect to see advertising continue to be a drag on

margin growth as the company is increasing prices and is moving ahead of its competition in doing so. As such, it will likely have to continue the emphasis on advertising in order to minimize market share loss.

Mondelez International (MDLZ) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
2-	2-

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

We maintain our *EQ Review* rating on Mondelez International (MDLZ) at 2- (Weak)

MDLZ reported adjusted EPS of $0.62 which was 2 cps ahead of expectations. However, the company missed on revenue. All the concerning trends we have noted before continued into the 9/18 quarter:

- While accounts receivable DSOs adjusted for outstanding sold receivables remains under control, MDLZ continues to expand its use of factoring to boost cash flow. This helped reduce the cash drain from receivables by $300 million in the quarter.

- Accounts payable days continue to skyrocket, climbing almost 9 days in the 9/18 quarter and adding about $180 million to cash flow growth in the period. As with receivables factoring, this level of cash flow boost cannot continue indefinitely and will be a significant drain on future cash flow growth if it reverses.

- Inventory DSI jumped by more than 3 days over the year-ago quarter. Last year's DSI figure may have been slightly depressed from the malware incident, but the current quarter still looks 2-3 days high compared to the 9/16 quarter. Finished goods as a percentage of total inventory also increased by 120 bps. The company turns its inventory relatively quickly and the fact that its cost inflation is being partially offset by lower cocoa prices reduces our concern that higher costs are being delayed from hitting the income statement. However, a 2-3 days increase in DSI focused in finished goods could indicate an unexpected buildup and warrants minor concern.

- MDLZ announced it is continuing the seemingly endless Kraft/MDLZ string of restructuring charges by extending the current plan through 2022 and adding another $1.3 billion in charges and $700 million capital spending.

Continued Expansion of Factoring

The following table shows the calculation of accounts receivable days (DSO) adjusted for receivables that were sold off but still outstanding under the company's factoring program:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$6,288	$6,112	$6,765	$6,966
Trade Receivables	$2,732	$2,416	$3,113	$2,691
Factored Receivables	$769	$719	$866	$843
Adjusted Receivables	$3,501	$3,135	$3,979	$3,534
Adjusted Receivable DSOs	50.8	46.8	53.7	46.3
Factored Receivable DSOs	11.2	10.7	11.7	11.0

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$6,530	$5,986	$6,414	$6,770
Trade Receivables	$2,981	$2,395	$3,035	$2,611
Factored Receivables	$650	$594	$630	$644
Adjusted Receivables	$3,631	$2,989	$3,665	$3,255
Adjusted Receivable DSOs	50.7	45.6	52.1	43.9
Factored Receivable DSOs	9.1	9.1	9.0	8.7

Adjusted receivable DSOs with were roughly flat with the year-ago period. However, outstanding factored receivables jumped by more than 18% year-over-year, driving factored receivable DSOs up to 11.2 from 9.1. This serves to boost cash flow growth in the current period as the receivables are monetized more quickly. We can see the benefit from the fact that receivables consumed $230 million in cash in the 3-month period ended 9/18 while they consumed $540 million in the comparable year-ago period. As we have noted in the past, there is nothing inherently wrong with receivables factoring other than the cost incurred to sell them including discounts. However, the question is how long the company can continue to expand the sale of receivables to boost cash flow growth.

Payables Continue to Balloon

MDLZ also continued to stretch payment terms on suppliers as days payable (DSP) rose by almost 9 days over the year-ago quarter:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$3,874	$3,572	$3,916	$4,295
Accounts payable	$5,374	$5,248	$5,727	$5,705
COGS YOY growth	-2.7%	-2.7%	0.5%	2.7%
Accounts payable YOY growth	4.6%	4.7%	16.9%	7.3%
Accounts payable DSPs	126.6	134.1	133.4	121.2

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$3,981	$3,672	$3,896	$4,181
Accounts payable	$5,139	$5,012	$4,897	$5,318
COGS YOY growth	1.9%	-3.0%	-0.6%	-7.7%
Accounts payable YOY growth	5.2%	9.9%	2.5%	8.8%
Accounts payable DSPs	117.8	124.5	114.7	116.1

As with receivables, there was a huge boost to cash flow growth in the quarter from increasing the time to pay suppliers. The increase in payables added $182 million to cash flow growth in the period compared to just $4 million in last year's third quarter. We pointed out in a previous review that the company would have a difficult time making its full-year forecast to generate $2.8 billion in free cash flow without continuing to aggressively expand its receivables factoring and payables extensions. While the company has managed to continue to do this, the question remains how much longer can cash flow growth receive this type of tailwind and at what point does it reverse.

Inventory DSIs Up

MDLZ's inventory also showed a noticeable spike in the quarter. As shown in the table below, inventory days (DSI) showed 3.2-day increase over the year-ago quarter:

	09/30/2018	6/30/2018	03/31/2018	12/31/2017
COGS	$3,874	$3,572	$3,916	$4,295
Inventory	$2,842	$2,683	$2,620	$2,557
COGS YOY growth	-2.7%	-2.7%	0.5%	2.7%
Inventory YOY growth	2.2%	-1.0%	0.7%	3.6%
Inventory DSIs	66.9	68.5	61.1	54.3

	09/30/2017	06/30/2017	03/31/2017	12/31/2016
COGS	$3,981	$3,672	$3,896	$4,181
Inventory	$2,781	$2,710	$2,603	$2,469
COGS YOY growth	1.9%	-3.0%	-0.6%	-7.7%
Inventory YOY growth	0.2%	-0.1%	-5.6%	-5.4%
Inventory DSIs	63.7	67.3	61.0	53.9

	09/30/2016	06/30/2016	03/31/2016	12/31/2015
COGS	$3,908	$3,786	$3,920	$4,529
Inventory	$2,776	$2,713	$2,756	$2,609
Inventory DSIs	64.8	65.4	64.2	52.6

Last year's 6/17 quarter was impacted by a malware attacked which resulted in a significant delay in orders, some of which were realized in the 9/17 quarter. The above DSI calculations are based on quarter-end inventory levels, so it is possible that the 9/17 quarter DSI figure was depressed by higher cost of sales during the quarter from "catch-up" sales while the quarter-end inventory balance was back to a normal level. However, even when we compare to the 9/16 DSI level of 64.8, the 66.9 figure at the end of the 9/18 quarter is two days higher.

Adding some to the concern is the fact that finished goods as a percentage of total revenue rose by 120 basis points, a marked acceleration over the previous two quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Raw Materials % of inventory	25.0%	26.0%	26.9%	26.5%
Finished Goods % of inventory	75.0%	74.0%	73.1%	73.5%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Raw Materials % of inventory	26.2%	26.6%	27.5%	27.9%
Finished Goods % of inventory	73.8%	73.4%	72.5%	72.1%

MDLZ utilizes the average cost inventory method which approximates FIFO. Therefore, current sales are matched against older inventory costs. While the company is experiencing some cost inflation, it is also benefitting from a decline in cocoa prices. In addition, inventories are turned in 60 days, so we are not overly concerned that profits are artificially benefitting from delaying the recognition of higher costs. Still, a sudden 2-3 day increase in

DSI, while not overly alarming, could be an indication of an unexpected buildup in inventory that could potentially result in higher than expected discounting.

More Restructuring on the Way

One of our biggest issues with the Kraft/MDLZ story is the never-ending streak of major restructuring charges the company and its predecessor have taken over many years. Therefore, it was not surprising to us that the company announced that it is extending the existing "Simplify to Grow" program. The company already planned to record charges of $5.4 billion and $2.3 billion in capex under the existing plan which began in 2014. However, the extension adds another $1.3 billion in charges, $700 million in incremental capital expenditures and another three years in time-frame (now through 2022.) Some of these charges are recorded as restructuring charges while those that do not meet the accounting requirements for disclosure as restructuring costs are recorded as "implementation costs." Both types are added back to adjusted non-GAAP results used to evaluate the company. This type of ongoing, ever-expanding restructuring program raises serious questions about the quality of these charge-adjusted earnings given the very real possibility that operating expenses such as management time and other ongoing expenses are being included in the charges and ignored.

Eaton Corporation (ETN) 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 maintain our *EQ Review* rating on Eaton (ETN) at 3+ (Minor Concern).

- Inventory continued to build in the quarter, rising by about 5 days over the year-ago quarter. Management attributed this again to pre-buying ahead of tariffs. Our concern level remains low at this point that there is an unexpected buildup in product.

- R&D expense fell again in the quarter, providing an almost 3 cps headwind to earnings growth. This boost will reverse should R&D revert to a historical level in upcoming quarters.

Inventory DSI Continues to Build

We have noted in the past that the company's inventory days (DSI) have been rising which management attributed to pre-buying ahead of tariffs. This trend continued into the 9/18 quarter as inventory days (DSI) rose by 5 days over last year's quarter (as adjusted for the change to 100% FIFO inventory accounting.) Management's explanation likewise remained the same in the third quarter conference call:

> *"I would say for sure we did, as I think we talked about a little bit last quarter, we did some pre-buying in terms of inventory to get out in front of the tariffs and protect our customers, and so we did build a little bit of inventory during the course of Q3 that we'd expect to unwind in Q4, and as we go forward. But nothing that I would say is material. Our cash flow numbers in the quarter, $1 billion dollars of free cash flow, and we are maintaining our guidance for the year, and so everything that we've done, we expect to largely unwind it during the course of the year."*

As we have noted before, the company's accounting change to utilizing 100% FIFO on all US inventories in the 12/17 quarter would serve to delay the recognition of higher-cost inventory in a period of rising raw materials costs like we are experiencing now. Given the combination of likely pre-buying and rising costs, we are not especially concerned that the observed increase in inventory represents an unusual buildup in excess inventory.

R&D Continues to Decline

Research and development expense registered another year-over-year decline:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$5,412	$5,487	$5,251	$5,213
R&D Expense	$138	$145	$156	$144
% of Sales	2.5%	2.6%	3.0%	2.8%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$5,211	$5,132	$4,848	$4,867
R&D Expense	$147	$150	$143	$145
% of Sales	2.8%	2.9%	2.9%	3.0%

If R&D had remained a constant percentage of revenue versus the year-ago period, it would have taken about 2.9 cps off of earnings. It is reasonable to expect R&D to return to its longer-term rate closer to 3% which will prove to be a headwind to earnings growth.

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.

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