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Contents

Brookdale (BKD Results- More Bad News for Welltower (WELL)

Brookdale Senior Living (BKD) reported results this week. They are a tenant of Welltower (WELL), which we follow more closely and have a negative view. In general, we are negative on this industry as the demographic tailwind doesn't arrive for 10-years and the supply is already here and getting larger. There were several interesting comments from Brookdale's President/CEO Cindy Baier and CFO Steve Swain that relates to trends impacting Welltower and we wanted to point them out.

- Occupancy remains weak at Brookdale too. This problem exists throughout the senior housing industry and new supply continues to come online.
- Brookdale saw significant pressure on move-in rents in 2017 and it is trying hold back on discounting now. Will new supply that is half-full match that approach? Also,

never forget churn is over 30% in this industry – a huge number of new residents are needed annually to maintain occupancy.

- Margins are being squeezed at Brookdale due to higher labor costs. That is expected to continue given the tight labor market and their same-store results show that these higher costs are having a larger negative impact on earnings. If occupancy remains under pressure – we think Brookdale lays out the model for lower margins very well that could impact others in this industry.

- Brookdale has new shared cost/shared investment arrangements with Welltower after restructuring many leases. They see their properties in need of some repair and upgrades and expect Welltower to pay for part of that. As we noted last week, this is more reason to deduct maintenance capital spending from Welltower's FFO figure for a more accurate view of the business with these new types of operating arrangements.

Occupancy Remains an Achilles Heel at Brookdale Too:

Brookdale has been fighting weak occupancy for years just like Welltower. We have talked about how the demographics of the Baby Boomers do not point to the oldest ones reaching the typical age of entering a senior living home until 2028. That's a demand problem. Brookdale was commenting about the overbuilt supply side of the equation.

> Cindy Baier:
> "*For 2019, we expect the competitive landscape will continue to be difficult, but there are early indications for improvement.* ***As previously reported by NIC, construction as a percentage of senior housing inventory remains near historical highs, yet it is starting to abate.*** *The number of starts and opens has been and continues to be on a downward trend this year. Through our custom data analysis, we determined that new openings are taking longer to fill up or stabilize. This may put additional pressure on underwriting future new construction. While the slower fill-up may put some pressure on rates, we have not seen widespread discounting.* ***Our current view is the supply headwinds will persist for the vast majority of 2019 before improvement."***
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> Answering a question, Cindy Baier added:

> “*Mary, we as well as the industry have been studying the competitive market pretty intensely.* ***I think virtually everyone sees a lot of new supply being delivered in 2019 and that supply delivery will add growth in 2019. So, when we look at that, we basically say we're going to be in a very difficult headwind.”***
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> Steve Swain discussed this more in results, ***“The third quarter 2018 same-community weighted average occupancy was 84.5%, a decline of 90 basis points compared to the prior year. This decline is essentially the same as NIC industry year-over-year averages.***
>
> ***The good news is that even with that rate discipline, we delivered a 20 basis point sequential improvement in the second quarter 2018.”***

Low Occupancy Has Pressured Move-In Rents

We have talked in the past that the average resident stays in Senior Housing about 30-36 months on average. Most are unlikely to move if the rent is raised a little as that involves effort by the resident and family. Plus, they may only get 1 or 2 increases during their stay. Thus, the way to control pricing is on the negotiated fees when the resident first moves in. Also, with the amount of churn, failing to replace a resident has a much larger income impact than replacing him with a person paying less. So that is the pressure in the market as the supply continues to grow and operators look to replace churn, boost occupancy, and fill new supply.

Last year, Brookdale was slashing move-in rates to try to maintain occupancy. Now it is trying not to discount to add new residents but is noting that it still isn’t as strong even against easy comps:

Cindy Brier commenting on slower conversions of leads to move-ins for 3Q18:

> “*The lower year-over-year move-ins were also due to a tough comparison since we drove occupancy through deeper discounts in the third quarter 2017. I previously referenced the negative 6% mark-to-market that occurred in the third quarter 2017. We've made significant strides to enhance our price discipline over the past year. And for the third quarter 2018, mark-to-market was within 1% of our existing residents’ rate, controllable move outs improved 4% on a year-over-year basis. This was the third consecutive quarter that we saw a significant improvement.”*

Keep in mind four things here:

1) The people moving in last year, are probably now 30% of the occupancy and they paid lower rents when moving in and replaced other residents that may have rolled off from a higher rent figure.

2) The improvement in new pricing this year sounds it still is at or below existing residents and the large group on a discount from 2017 would have lowered the average rent of existing residents.

3) A big part of helping the quarter was preventing additional move-outs. That is commendable, but those elderly people will still eventually churn in the future.

4) Brookdale boosted occupancy in 3Q and 4Q17 with the discounts. That gave them less panic to make cheap deals in 2018. However, as those 2017 residents churn, will Brookdale be able to maintain flat pricing power and risk greater drops in occupancy?

Labor Costs Are Rising and Are Squeezing Margins at Brookdale:

Brookdale is trying to retain staff and salespeople more and is investing in additional people. This plan for growth is expected to last 3-years through 2020. As we have been saying with Welltower, one of the problems with this business is a high fixed cost for operating expenses combined with a variable revenue stream tied to occupancy that is under pressure. Now the operating costs are rising at the same time. The result is deleveraging of the operating model:

> Cindy Baier:
> "*Regarding community labor costs, I previously mentioned the 2018 was the second of a three year investment plan to bring our product line associates up to our goal threshold.* ***Our 2018 labor cost growth compared to 2017 is expected to commence lately lower than 5.5% which was the low end of our previous range. The labor market continues to be tight and we expect our labor investments will continue into 2019."***
>
> Steve Swain:
> "O*ur third quarter 2018 consolidated same community operating expenses increased 4.5% compared to prior year quarter.* ***Same community total compensation increased***

> ***5.5% for the third quarter and 5.1% year-to-date compared to the prior year periods. This reflects a wage pressure due to a tight labor market plus our intentional above industry investments in key resident facing associate salaries along with more robust benefits to improve our ability to recruit and retain the best associates in the industry.***
>
> ***With increased investments and compensation and because facility operating expense does not scale perfectly with lower occupancy, our community operating expense increased faster than our revenue growth, leading to a same community operating income decline of 8.2% compared to the third quarter 2017."***

The last paragraph is a key point in our view. Remember, that is with and 84.5% occupancy rate and this business cannot absorb wage increases. The plan for Welltower and others going forward is to partner in shared-cost/shared-revenue structures on lower occupancy units. Most of what we see from this industry points to higher wages and pressure on occupancy continuing. We would not expect many of these new shared-deals to show meaningful results for some time.

Brookdale Expects More Capital Spending Will Be Needed and Help from Partners

Brookdale has been terminating lease deals with Welltower and Ventas over the last year and restructuring other financial deals on other properties. Brookdale noted its leased portfolio is now down 22% since 3Q17. In this year, they terminated more leases with HCP and two more with Welltower.

We talked last week how Welltower's results need to include higher capital spending to be apples-to-apples in comparing results year to year. Welltower has touted the higher FFO (Funds from Operations) as a result of having many fixed rent triple-net lease deals like the ones with Brookdale convert to the RIDEA structure where both parties share costs. Also, we believed that many triple-net properties that were in trouble probably did not get the full amount of maintenance spending by the tenant. As those deals become RIDEA instead of triple-net leases – suddenly Welltower has to pay more of the costs of operation and capital spending. Brookdale could not have said it any more clearly on their 3Q18 conference call:

Cindy Baier:

"The final significant part of our 2019 outlook is related to CapEx. As previously mentioned, I initiated a review of our community CapEx needs immediately after I became CEO. The team recently completed this discipline, bottoms up review ***for our 700 plus community consolidated portfolio with a focus on ensuring that our communities are in appropriate physical condition to support our turnaround strategy. As part of the review, we also determined what additional investments are needed to protect the value of our portfolio. As a result of that review and based on our preliminary 2019, we now anticipate additional near-term investment in our communities including for 2019 increased spend on our community level CapEx primarily attributable to major building infrastructure projects.***

We expect the portion of this increased CapEx will be reimbursed by our REIT partners. *And net of such reimbursement* ***we currently anticipate that our non-development CapEx for 2019 to be up to $75 million*** *higher than our 2018 spend."*

Steve Swain:

"In addition, following the quarter end, Brookdale and Welltower agreed to renew the Sallie master lease for the next 8 years. This mutually beneficial agreement results in a greater alignment of interests. For example, Welltower will fund the pool of first dollar capital investments which will improve our near-term cash flow."

Thus, Welltower is expected to spend money to improve Brookdale's cash flow and enhance the deal. Investors need to be subtracting investments to existing properties as capital spending from Welltower's FFO. Doing that shows that Welltower's valuation multiple rises and its growth becomes flat to negative.

Ocean Yield (OCY NO, OYIEF) 3Q18 Update
Changing to NEUTRAL from BUY

Ocean Yield (OCY NO, OYIEF) did not renew the contract on its FPSO vessel with Reliance in India. Liquidity remains strong and the company is forecasting no dividend cuts. Management is pursuing multiple opportunities and believes the FPSO will have a new long-term contract in the first half of 2019. The vessel is debt-free and we have noted that with the focus on retiring its debt faster – cash flow from the FPSO was not fully available to cover the company's dividend in recent years.

The fleet growth in other areas continues with Ocean Yield now at 57 ships and we only see one more problem regarding its customer Solstad with two oil support vessels. The nearly 10% yield is attractive and there appears to be enough cushion to support the dividend much longer than it should require to resolve the FPSO situation. **We will go a NEUTRAL rating until we see what Solstad does as that does represent a new issue.**

- FPSO is finishing clean-up issues and preparing to receive customs clearance to move. Ocean Yield reserved $28 million for demobilization already. A cash infusion is expected as final receivables are paid. Management sees a new contract in 1H19.

- FPSO cash flow is not necessary to pay the dividend. A new contract should provide room to grow the dividend in 2H19.

- Annualizing cash flow from recent new ships should boost results further. Outlook for stronger results for the Connector should also help 1H19.

- Solstad is looking to boost liquidity and charters two ships from Ocean Yield. It is possible Ocean Yield will not be approached because it already restructured its Solstad charters in 2017. However, a write-down in the stock received from Solstad in 2017 is likely and it's unclear how extensive Solstad's activities may become.

We believe the company has adequately planned to support the dividend during the period when the FPSO is without a contract. However, it will likely need to hit its forecast to sign a new long-term contract in the first half of 2019 or sell the FPSO to maintain the current dividend level beyond 2019. Solstad represents about $8.8 million in EBITDA per year.

That is a meaningful amount if Ocean Yield needs to waive charter revenues for 3-6 months. It is not close to the level of the idle FPSO – but that situation has been addressed and planned for during the last three years.

FPSO Situation:

The 10-year contract was completed on September 19. That it was not extended is not surprising because the contract price exceeded current market rates. Also, the field was unlikely to operate more than a few more months had it been retained. The vessel is now free from hookups in the field and is ready be cleared by customs and moved to a new site.

As part of settling up remaining payments, there is $53 million in receivables from the prior charter customer – Reliance Industries. ($4.2 million has come in since the end of 3Q.) Ocean Yield expects this remaining receivables and payments for miscellaneous end-of-the-deal activities to be resolved in November and that should release a large amount of cash into the company.

Ocean Yield recorded a provision already of $28 million to demobilize and move the vessel. That will turn into a cash outlay in 4Q18 and 1Q19 and includes some operating expenses while it is still in India.

The company sees increased interest in the FPSO for several reasons: 1) there is a better outlook for developing oil/gas fields, 2) there is no longer a purchase option with Reliance, which kept many potential charterers away as they didn't want to do the preliminary work on suitability if there was a chance they could never get the vessel, and 3) there are discussions ongoing with several parties simultaneously at this time.

The company could still sell the vessel but believes it is more likely to have a long-term contract in the first half of 2019. It is possible there will need to be some modification to the vessel depending on the potential project and location. More than likely, any modification would occur after a new contract is signed and a cash flow stream can be forecast. Ocean Yield still sees the vessel as having a 20-year life. It is debt-free so any cash flow that comes in from either a sale or contract will be fully available to shareholders or additional company growth. The carrying value is $255 million and given the projected range of future cash flows, management does not expect to record an impairment. However, to be conservative, they have given a range of $0-$50 million for any potential impairment taken in the next couple of quarters.

A quick summary for the FPSO is it should be resolved in 1Q or 2Q of 2019 – either a new contract or sale. Moving the vessel could involve cash costs of up to $30 million, but $28 million has already been expensed against earnings. There is $53 million of receivables owed on the prior contract and that should result in a large cash flow in 4Q18.

The Dividend Does Not Rely on the FPSO Operating in the Next Year

We have talked about this before. Here are cash needs for Ocean Yield for the next twelve months ending September 30, 2019:

> $36 million for expected capital spending. This is for 1 Suezmax that was delivered on October 25, two chemical tankers delivered October 29, and 4 VLCC tankers coming in 2Q and 3Q 2019. The $36 million is net of $322 million of financing already in place.
>
> $96 million in interest expense. 3Q18 interest was $22.1 million, which we annualized and then added some additional interest expense for the loans on the new ships – which will be more backloaded for the VLCCs arriving later in 2019.
>
> $109 million for scheduled debt maturities over the next 12 months.
>
> $122 million for the dividend over the next four quarters.
>
> $30 million demobilization outlay for the FPSO to be moved.

That totals $393 million in cash needs. The company remains very liquid with $173 million in cash plus available credit of $37 million. Also, it will receive some portion of the $53 million in FPSO related receivables this month.

Let's use round numbers and say Ocean Yield has $250 million in cash and near-cash against $400 million of cash needs to fund the dividend, growth, debt payments, and movement of the FPSO. Obviously, they will not use all that cash and liquidity for the dividend. However, the company will generate EBITDA as well. Last quarter was $100.4

million with $26.3 million from the FPSO. So, adjusted down for the idle FPSO, it's $74.1 million. **Again, round numbers $300 million over the next 12 months from EBITDA.**

On top of that, there will be the full quarterly results for the 3 Suez tankers and 2 chemical tankers. That should add to the $300 million. The new VLCCs will all arrive in 2Q and 3Q and start producing EBITDA too. If the target is to have a new long-term contract for the FPSO in the first half of 2019, the FPSO may start producing EBITDA again before the end of the 12-months. The Connector is also on contract into mid-November with an option to extend to the end of December. Interest in the vessel is improved for post-winter 2019 for more consistent cash flow results with a longer contract, rather a series of 2-4 month engagements.

After the next 12 months, Ocean Yield will not have the $36 million in capital spending, the $30 million in demobilization cash outlay, and cash needs become essentially $320 million per year for interest, debt maturities, and the dividend (Unless it adds more ships which in turn add more EBITDA). The FPSO was producing almost $115 million in EBITDA per year. The new contract will come in lower than that – maybe even less than half that, but the vessel is debt free and with the new ships and the FPSO operating, the company looks likely to cover all cash needs without refinancing debt or tapping liquidity.

We also want to point out that Ocean Yield spent recent years prepaying the FPSO's debt to $0 and that was consuming the bulk of its cash flow. In 2016, EBITDA from the FPSO was $115 less interest expense and debt retirement of $75 million – so only $40 million was available for other corporate cash needs. In 2017, FPSO EBITDA of $116 million paid $84 million in interest and debt retirement leaving only $32 million from the FPSO. **So, the FPSO can come in at a much lower contract price and may still produce more than $30-$40 million in cash for general corporate purposes annually.**

A quick summary here – the company is targeting a flat dividend until the FPSO situation is resolved. Cash and near cash are about $250 million at the moment and $300 million of EBITDA is likely in the next 12 months assuming nothing from the FPSO. Management sees that and knows it has $400 million in cash outlays too which includes the dividend. They are willing to spend cash in the short term to maintain the dividend until the FPSO is working again. If that doesn't happen for some reason or it is delayed for an excessive amount of time – then they will need to either cut the dividend in our view or sell the FPSO and reinvest that cash in other ships.

Solstad Offshore Is a Possible Unforeseen Issue

Solstad is a company that charters a number of ships for offshore support to the oil and gas industry. Jon Fredrickson who owns Seadrill owns a large stake in Solstad. In early 2017, the company was looking to restructure some of its charters due to softness in the market. The view was the offshore market would improve within five-years and in return for a lower day-rate early on, a company like Ocean Yield would receive shares of stock, a potential cash sweep if day rates on the vessels exceeded targets and a balloon payment.

Ocean Yield took the deal and cut its rates on the two ships to about $12,000 per day (we are converting NOK to USD at current levels) or $4.4 million per year through 2021. ($8.8 million for two ships.) They will increase to $25,000 per day in 2022-23 and there is a total balloon payment of over $30 million after that. If the market recovers, the $30 million balloon can be prepaid with cash sweeps through a profit-sharing arrangement. And they received stock worth about $15 million at the time that was subsequently written down to $6.5 million and is now valued at $5.3 million given the state of current Solstad.

Solstad is approaching creditors and customers to boost liquidity again during the coming winter when business is seasonally slower. Also, the market has not turned as fast as forecast. The CEO told Reuters in late October, *"We were all too optimistic about when the recovery will happen." 2019 will probably be a bit better, but we will need to wait until 2020 or 2021 to see the rates rising to reasonable levels."*

We do follow the offshore market a bit and we have seen some similar comments from rig operators – essentially, they are winning some new contracts, business seems to be turning up, but it's not recovered yet. It's much better than late 2016 and early 2017 when Solstad restructured last time. But, pricing has not fully returned. **Marc Edwards the President of Diamond Offshore commented this week on what it is seeing in offshore drilling:**

> *"We believe the day rates in the floater (type of rig) market have bottomed, and although we are unsure as to the velocity of any recovery, we believe day rates will generally improve from here on in."*
>
> *"We believe the moored (another type of rig) market has hit bottom. We have previously stated that there has been tightening in the North Sea, but is not limited to just that region. We are seeing it in non-harsh markets as well, where we are*

attaining incremental price increases as a result. Customers are looking to lock in capacity for 2020 and beyond as they see the coming strengthening of this asset class."

"We also believe the DP market has bottomed, but the question remains what type of recovery we will have. We do not expect day rates to recovery rapidly; however, we do believe the rates have found a floor and there is more upside than downside from her forward."

"Now moving to our contracting activity, recall that in the second quarter Diamond was able to secure an additional five years of backlog with three major operators: Shell, BP, and Anadarko at rates significantly above the prevailing market. In the past quarter, we are announcing three additional contracts, one in the North Sea and two in the Australasia region."

The recovery may be near and new activity is more widespread. We have commented before about the level of reduced investment by the oil companies was unprecedented after 2013, which has set up the offshore market for a rebound as current wells decay and production declines.

So Solstad is looking to sell vessels, raise money from equity holders, or defer payments with creditors. The focus is to get through the next two quarters and it may not be as major of a restructuring as before. Also, with the Ocean Yield charters already reworked, the focus may be on ships with higher lease payments with other counterparties. We do not think that some percentage of lost revenue from the $8.8 million current charter upends the Ocean Yield cash flow forecasts. Any negative news from Solstad will likely flow to its counterparties' stocks.

However, there are potentially larger risks if Solstad looks for a more extensive restructuring and tries to cull some of its fleet. It is likely the Solstad stock owned by Ocean Yield may see an impairment and a further reduced day rate (or waiver period on charter revenue) could offset some of the growth in cash flow from the new Suexmax tankers that have not had a full impact on results yet. If it became worse, it would be a bigger issue if Solstad defaulted on the charters and there was a longer period of time without charter revenue. That is worst-case as Solstad has deep pockets behind it and it should be easier to do some minor restructuring with the market showing signs of recovery than it was in 2016. **However, we will go to a NEUTRAL rating on Ocean Yield as this situation plays out.**

Church & Dwight (CHD) 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 are maintaining our 2+ (Weak) rating on Church and Dwight (CHD).

CHD reported EPS of $0.58 in the 9/18 quarter, 4 cps ahead of the consensus estimate which the company attributed to a higher-than-expected top-line growth and lower-than-expected tax rate. Given the lack of visibility into receivables and rising inventories, we maintain our 2+ (Weak) rating.

- Accounts receivable days (DSO) fell by almost 4 days from the year-ago quarter. The year-ago DSO was elevated from last year's Pik Holdings acquisition. Still, the receivables balance itself declined year-over-year.

- However, the lack of visibility into the company's quarterly receivables securitization activity adds a degree of uncertainty to tracking trends in revenue recognition and cash flow growth.

- Inventory DSIs continued to increase, climbing almost 4 days above the year-ago level. While higher levels of inventory at the acquired Pik Holdings business may have influenced the increase seen in the last few quarters, that has now lapped and it is out of the comparison. In fact, the year-ago DSI was likely *inflated* by the impact of the acquisition which actually muted the reported increase in the DSI.

- Accounts payable DSPs showed a noticeable jump in the quarter as the company extends payment time on its suppliers.

DSOs Are Down but Lack of Visibility Still Clouds

Accounts receivable DSOs in the 9/18 quarter fell by almost 4 days compared to the year-ago quarter:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$1,038	$1,028	$1,006	$1,033
Accounts Receivable	$362	$349	$361	$346
Sales YOY growth	7.2%	14.5%	14.7%	15.3%
Accounts Receivable YOY growth	-4.3%	14.7%	18.3%	20.5%
Accounts Receivable DSOs	31.8	30.9	32.8	30.6

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$968	$898	$877	$896
Accounts Receivable	$378	$304	$305	$287
Sales YOY growth	11.2%	2.3%	3.3%	2.6%
Accounts Receivable YOY growth	42.4%	8.9%	10.2%	3.9%
Accounts Receivable DSOs	35.6	30.9	31.7	29.2

However, the year-ago DSO was inflated by the Pik Holdings acquisition during the final month of the 9/17 quarter. Nevertheless, the receivables balance itself declined implying the balance of the account is under control.

However, investors should still be mindful of the fact that the company maintains a receivables factoring program about which it discloses no quarterly detail. This leaves open the possibility that receivables could have been sold off and removed from the balance sheet which would cloud the real level of receivables at the end of the quarter as well as accelerate cash receipts. Admittedly, we would expect the company would disclose it if a meaningful quantity of receivables were sold off in the quarter. Still, we know the company factored over $100 million in receivables during 2017 which is more than capable of distorting a DSO analysis depending upon timing during a quarter. We will have more disclosure on this issue when the 2018 10-K comes out next year.

Inventories Continue to Climb with Buildup in Finished Goods

The following table shows that CHD's inventory days (DSI) continued to climb on a year-over-year basis.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$578	$573	$555	$552
Inventory	$391	$369	$357	$331
COGS YOY growth	9.1%	17.5%	16.0%	13.1%
Inventory YOY growth	16.2%	26.3%	27.5%	28.1%
Inventory DSIs	61.7	58.8	58.8	54.7

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$529	$488	$478	$488
Inventory	$336	$292	$280	$258
COGS YOY growth	11.4%	3.9%	1.7%	2.5%
Inventory YOY growth	17.6%	0.7%	-3.7%	-5.8%
Inventory DSIs	57.9	54.7	53.5	48.3

	9/30/2016	6/30/2016	3/31/2016	12/31/2015
COGS	$475	$469	$470	$476
Inventory	$286	$290	$291	$274
Inventory DSIs	54.9	56.4	56.5	52.5

We can see that the Pik acquisition drove a 17.6% YOY increase in inventory in the 9/17 quarter. As with receivables, the company's 8/7/2017 acquisition of Pik Holdings would have inflated the DSI number in the 9/17 quarter by 1) only one month of cost of sales being included with the full amount of inventory impacting the calculation and 2) Pik likely carrying a higher level of inventory relative to cost of sales given the nature of the business. Still, in the quarters following the deal, inventory continued to grow at almost double the rate of cost of sales. In addition, the YOY increase in DSI was only three days from the 9/16 quarter to 9/17 quarter and that only widened in the following quarters. Now, in the 9/18 quarter, we still see a 16.2% increase in inventory on a 9.1% increase in cost of sales despite the fact that the 9/17 quarter included all of Pik's inventory and only about two-thirds of its cost of sales. We see this as an indication more of a buildup in inventory at the whole company rather than reflective of Pik having an intrinsically higher DSI.

We believe more evidence of this is still seen in the breakdown of inventory components seen below:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Raw Materials % of inventory	21.9%	23.7%	24.8%	25.9%
In-Progress % of inventory	8.5%	8.7%	9.8%	9.3%
Finished Goods % of inventory	69.6%	67.6%	65.4%	64.8%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Raw Materials % of inventory	24.6%	25.6%	25.1%	27.0%
In-Progress % of inventory	10.1%	11.3%	10.0%	11.2%
Finished Goods % of inventory	65.2%	63.1%	64.9%	61.8%

Finished goods as a percentage of total inventory has been on the rise the last four quarters. Key to note once again is that the percentage jumped by more than 400 bps YOY in the 9/18 quarter and both periods included the acquired Pik inventory. The only comment we have seen from management on inventory was in the 9/18 10-Q:

> *"The increase in the cash conversion cycle is **primarily due to certain acquisitions, which currently require a higher level of working capital.** We continue to focus on reducing our working capital requirements."*

This seems to address why inventory is higher than it was prior to the Pik acquisition but not the increase from the 9/17 to 9/18 quarters.

We also remind investors that the company switched the 17% of its inventories accounted for under LIFO to the FIFO method at the beginning of the 6/18 quarter. Prior quarters have not been restated as the company has deemed the impact immaterial. Regardless, in a period of rising costs, FIFO will result in a higher ending inventory balance than under LIFO and this could be driving some of the increase we are seeing. As such, these are costs that are being delayed from hitting the income statement, although the company's DSI of 60 days limits the delay.

There are many factors impacting the company's inventory balance, but all things considered, we remain cautious on the company's inventory level.

Payables Are Now Rising

We noted in our review of CHD's 6/18 quarter that the company's account payable growth had been under control in the previous three quarters. However, payables growth accelerated relative to cost of sales in the 9/18 quarter:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$578	$573	$555	$552
Accounts payable	$450	$420	$405	$399
COGS YOY growth	9.1%	17.5%	16.0%	13.1%
Accounts payable YOY growth	15.2%	11.9%	17.0%	20.3%
Accounts payable DSPs	71.0	66.9	66.7	66.0

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$529	$488	$478	$488
Accounts payable	$390	$375	$346	$332
COGS YOY growth	11.4%	3.9%	1.7%	2.5%
Accounts payable YOY growth	22.1%	18.6%	13.0%	12.8%
Accounts payable DSPs	67.3	70.2	66.1	62.0

Once again, we see that days payable (DSP) was inflated in the 9/17 quarter by the Pik acquisition just like DSOs and DSIs. However, the 3.7-day YOY jump to 71 seen in the 9/18 quarter is a noticeable increase. Management noted in the 10-Q filing for the 9/18 quarter:

> *"The change in working capital is primarily due to an increase in accounts payable and accrued expenses as we continue to extend payment terms with our suppliers…"*

The increase in payables and the absolute level of DSPs has not reached the ridiculous proportions we have seen with some other companies, but the benefit from stretching payables will run out at some point.

Mohawk Industries (MHK) 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 maintaining our 3- (Minor Concern) rating on Mohawk (MHK).

MHK reported its second disappointing quarter in a row, missing EPS estimates by $0.29 as well as coming up short on the top-line. Management blamed weaker than expected sales, less effective price increases, higher inflation, higher transportation costs, manufacturing reductions from excessive inventory levels, product mix and competition.

- Bad debt allowance remains at relatively low levels compared to recent quarters.

- We warned that reserves for warranties declined in the 6/18 quarter. This reversed back to more normal levels and we speculate it could have contributed to the earnings shortfall in the quarter.

- Inventory continued to grow in the quarter with the buildup focused in finished goods. The company's use of FIFO inventory delays the impact of rising costs on the income statement. We believe risks remain from elevated inventories.

- Amortization of costs to obtain contracts fell sharply in the quarter which likely provided a material boost to profits in the period.

- Contract liabilities (deferred revenue) declined sequentially in the quarter. While not a huge concern given the lack of history to compare to, this is still something to be watchful of in upcoming quarters.

Bad Debt Allowances Remain Low

In our review of the 6/18 quarter, we noted that bad debt allowances had declined materially from the year-ago quarter on an absolute basis and as a percentage of trade receivables:

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Customer Trade Receivables	$1,726.93	$1,716.75	$1,674.52	$1,538.35
Allowance for Bad Debt	$81.57	$78.14	$90.88	$86.10
Allowance %	4.7%	4.6%	5.4%	5.6%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Customer Trade Receivables	$1,660.99	$1,651.77	$1,508.93	$1,386.31
Allowance for Bad Debt	$91.25	$91.47	$81.24	$78.34
Allowance %	5.5%	5.5%	5.4%	5.7%

We see that while the allowance increased slightly sequentially, the allowance percentage remains low compared to the last several quarters. As we noted in the last review, it would take a charge of well over 15 cps to raise the allowance percentage to a mid-5% level.

Warranty Reserve Increased and Was a Likely Drag on the Quarter

We warned in our 6/18 quarter review that the company's warranty reserve dropped noticeably in the second quarter:

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$2,545.80	$2,577.01	$2,412.20	$2,369.10
Warranty Reserve	$44.62	$38.97	$40.46	$39.04
Allowance % of Sales	1.8%	1.5%	1.7%	1.6%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Sales	$2,448.51	$2,453.04	$2,220.65	$2,182.57
Warranty Reserve	$44.20	$45.08	$46.56	$46.35
Allowance % of Sales	1.8%	1.8%	2.1%	2.1%

However, we see in the above table that the reserve showed a sharp sequential increase both absolutely and as a percentage of revenue. The sequential increase of $5.6 million by itself could have reduced EPS by approximately 6 cps in the 9/18 quarter.

Inventory Remains Elevated

MHK noted as far back as the beginning of 2018 that its inventories were too high and it was working to bring them down. We noted in our review of the 6/18 quarter that while inventory balances had moderated some, DSIs remained high and the company's use of FIFO (first-in, first-out) accounting coupled with its long inventory turns would delay the recognition of higher costs on the income statement. Not surprisingly, management cited reduced manufacturing due to excessive inventories and higher than expected inflation as key reasons for its large earnings miss in the quarter. Despite the reductions in production, inventories still appear elevated at the end of the 9/18 quarter:

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Inventory	$2,214.30	$2,061.20	$2,044.96	$1,948.66
COGS	$1,825.37	$1,810.46	$1,707.51	$1,615.47
DSI	110.7	103.9	109.3	110.1

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Inventory	$1,911.03	$1,865.94	$1,740.88	$1,675.75
COGS	$1,665.21	$1,673.90	$1,540.29	$1,491.57
DSI	104.7	101.7	103.1	102.5

MHK closed the acquisition of Godfrey Hirst, Australia's largest floor manufacturer, on 7/2/2918. The acquisition price was $412 million but the company has yet to finalize its allocation of the purchase price so we do not know how much it booked in acquired inventory. Regardless, while the deal would have increased inventory levels, the fact that the quarter would have also contained virtually a full quarter of cost of sales for the acquired company means there would be a minimal impact on our calculation of quarterly DSI. Thus the 6-day YOY increase in DSI is likely indicating both a continued buildup in inventory as well as a reflation of the higher costs the company is citing. A look at inventory components shows that the buildup was centered in finished goods, further increasing the concern:

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Finished Goods % of inventory	69.5%	70.2%	68.6%	68.0%
In-Progress % of inventory	7.5%	7.6%	8.2%	8.2%
Raw Materials % of inventory	23.0%	22.2%	23.2%	23.7%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Finished Goods % of inventory	68.6%	69.7%	69.3%	67.3%
In-Progress % of inventory	7.9%	8.0%	8.4%	8.2%
Raw Materials % of inventory	23.5%	22.3%	22.2%	24.5%

We are therefore somewhat confused by management's comment in the conference call regarding the increase in inventory:

> *"What I'm saying also is that with the raw material inflation, you have the raw materials hitting the balance sheet before the sales prices have gone up. So the inventory turns get worse because the raw materials have increased, and it's showing up in the inventory dollars, in addition to having nothing to do with the units as the prices go up."*

While raw materials balances did increase by 14% in the period, finished goods jumped by 17% and was a much larger driver of the overall increase in inventory.

All of these factors make us think we have not seen the last of the negative impacts from the company's inflated inventory balances.

Amortization of Costs to Obtain Contracts

Under the new ASC 606 guidelines for revenue recognition, MHK began reporting its capitalized costs to obtain new contracts as well as periodic amortization of those costs in 2018. MHK describes its capitalized costs to obtain contracts as follows:

> *"The Company historically incurs certain incremental costs to obtain revenue contracts. These costs relate to marketing display structures and are capitalized when the amortization period is greater than one year, with the amount recorded in other assets on the accompanying condensed consolidated balance sheets."*

The company discloses the ending balance of capitalized contract costs and the YTD amortization of those costs by quarter. We utilized these amounts to construct the following table:

	9/29/2018	6/30/2018	3/31/2018
Beginning Balance of Capitalized Costs to Obtain Contracts	$50.400	$46.224	$43.259
Amounts Capitalized (Plug)	$14.280	$25.331	$17.679
Quarterly Amortization of Costs to Obtain Contracts	($7.629)	($21.155)	($14.714)
Capitalized Costs to Obtain Contracts	$57.051	$50.400	$46.224

We can see that the company's rate of capitalization dropped off dramatically in the 9/18 quarter which we assume indicates that it did not sign any new contracts requiring the placement of store marketing displays. Therefore, we would expect to see a slight decline in quarterly amortization, but certainly not for it to fall by more than 60%. It is difficult to imply much from just three quarters of data, but the huge decline in quarterly amortization expense looks unusually low and could represent a material headwind to results if it reverses in upcoming quarters.

Contract Liabilities (Deferred Revenue) Declined Sequentially

Under the new ASC 606 accounting for revenue recognition, MHK began reporting contract liabilities in 2018. These amounts are essentially deferred revenue, or revenue that the company has booked ahead of satisfying all its associated obligations. These amounts are shown for the last four quarters:

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Contract liabilities	$34.42	$42.94	$35.96	$29.12
Sales	$2,545.80	$2,577.01	$2,412.20	$2,369.10
Days of Sales	1.23	1.52	1.36	1.12

Any sequential decline in a deferred revenue account is noteworthy as it indicates revenue was recognized without a similar-sized future amount taking its place in the "pipeline." However, without a year-ago quarterly balance to compare to, these figures have limited analytical value. In addition, contracts spanning multiple quarters would not seem to be a major part of the company's business model which make this seem less relevant.

Kellogg (K) 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 are maintaining our rating on Kellogg (K) of 2+ (Weak).

K reported adjusted EPS of $1.06 which was a penny below the Zack's estimate. Revenue came in slightly ahead of targets. The miss was largely due to higher-than-expected inflation coupled with higher marketing and brand-building costs. The company also disappointed the market by lowering EPS guidance for the full year while boosting sales guidance. Our concerns noted in the previous quarter remain:

- Accounts receivables sold or securitized at the end of the 9/18 declined from the year-ago period. This led to accounts receivable days of sale (DSO) adjusted for sold receivables declining by 7 days. As we have noted before, K appears to have reigned in its extension of payment terms with customers which it aggressively used in 2017 yet is still meeting sales targets. However, we note it is spending more on "brand building" to do so.

- Accounts payable days (DSP) were flat with the year-ago quarter after rising rapidly in 2017 as the company has leveled off on the use of its structured payable programs. This resulted in cash provided by payables declining by $26 million in the 9/18 quarter versus a year ago. While free cash flow looks more than sufficient to cover the dividend, the cushion could narrow in 2019 absent the company resuming its receivables sales and payables extension.

- Project K charges should fall off in 2019 and we will be skeptical of the extension of any restructuring plans next year.

Adjusted Receivables Trend Lower with Lower Receivables Sales

We discussed in our review of the 6/18 quarter that both the origination of new accounts receivable as well as the sale of receivables began to slow in at the beginning of 2018. This led to a decline in days of sales (DSO) for both sold receivables balances as well as total adjusted receivables (reported receivables plus outstanding balances of sold receivables.) This trend continued into the 9/18 quarter:

	9/30/2018	6/30/2018	3/31/2018	12/30/2017
Sales	$3,469	$3,360	$3,401	$3,209
Reported Receivables	$1,612	$1,530	$1,601	$1,389
Sold Receivables	$965	$962	$970	$1,120
Sold Receivable DSOs	25.4	26.1	26.0	31.8
Total Adjusted Receivables	$2,577	$2,492	$2,571	$2,509
Total Adjusted Receivable DSOs	67.8	67.7	69.0	71.3

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Sales	$3,246	$3,175	$3,248	$3,097
Reported Receivables	$1,512	$1,427	$1,464	$1,231
Sold Receivables	$1,154	$1,133	$1,014	$978
Sold Receivable DSOs	32.4	32.6	28.5	28.8
Total Adjusted Receivables	$2,666	$2,560	$2,478	$2,209
Total Adjusted Receivable DSOs	74.9	73.6	69.6	65.1

Total adjusted receivables at the end of the 9/18 quarter declined from the year-ago level leading to a 7-day decline in total adjusted receivable DSOs. The company no longer appears to be extending more generous payment terms to customers, yet it continues to meet and exceed its sales targets. We note that it is requiring more “brand building” to do so. The anniversary of the termination of the Securitization Program and the overall decline in the pace of receivables sales will hit in the 3/19 quarter. It will be interesting to track the trends in DSOs beginning in that quarter to see if the company continues to be disciplined in its use of credit terms to customers.

Days Payable Now Flat

The normalization in accounts payable growth we noted in our previous quarterly review continued into the 9/18 period. The table below shows the calculation of days payable (DSP) and the percentage of payables that are in the company’s payables tracking system:

	9/30/2018	6/30/2018	3/31/2018	12/30/2017
Cost of Sales	$2,293	$2,151	$2,149	$1,888
Payables	$2,367	$2,306	$2,230	$2,269
DSP	94.2	97.8	94.7	109.7
Payables in Tracking System	$889	$834	$724	$850
% of Total Payables	37.6%	36.2%	32.5%	37.5%
Payables Sold by Suppliers	$664	$572	$547	$674
% of Total Payables	28.1%	24.8%	24.5%	29.7%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Cost of Sales	$2,074	$1,950	$2,088	$2,121
Payables	$2,140	$2,057	$1,995	$2,014
DSP	94.2	96.3	87.2	86.6
Payables in Tracking System	$798	$769	$731	$677
% of Total Payables	37.3%	37.4%	36.6%	33.6%
Payables Sold by Suppliers	$582	$556	$543	$507
% of Total Payables	27.2%	27.0%	27.2%	25.2%

Recall that the company was previously accelerating the use of its structured payable arrangements (tracking system) whereby certain suppliers could sell their receivables from the company to third-party credit companies to accelerate their receipt of cash. This allows K to delay paying suppliers while still capturing early-pay discounts. This was resulting in a rapid increase in payables and DSPs which began to level off in the 6/18 quarter. In the 9/18 quarter, the growth in payables fell more in-line with cost of sales growth leading to flat year-over-year DSP growth. Likewise, we can also see that that the year-over-year growth in the percentage of total payables in the tracking system has now leveled out (37.6% at 9/18 versus 37.3% at 9/17). This is resulting in a drag on cash flow growth. In the case of the 9/18 quarter, cash generated by accounts payable fell to $39 million from $65 million in the year-ago quarter. This drag on cash flow growth should continue into the first half of next year assuming the company does not resume its delay in paying suppliers.

To examine operating cash flow on a trailing-12 basis, we must adjust the reported operating cash flow for the 9-month period ended 9/17 to add back the cash flow from retained interest on sold receivables which is now reported in investing cash flows in 2018. In addition, the 2018 period includes a one-time $250 million contribution to the company's pension plan. These adjustments are shown in the following table:

	9 mos ended 9/18	9 mos ended 9/17
Reported Operating Cash Flow	$926	$190
Add back of retained interest	$0	$945
Adjusted Operating Cash Flow	$926	$1,135
Pension Contribution	$250	
Adjusted Operating Cash Flow	$1,176	$1,135

These adjusted 9-month numbers result in a trailing-12 cash from operations figure of $1.69 billion which more than covers the trailing-12 capex number of $516 million and the current trailing-12 dividend of approximately $750 million. Regardless, the cash dividend coverage will likely narrow further in 2019 absent any renewal in receivables sales or payment term extensions.

Project K Charges Should Wind Down

The company still maintains that Project K savings will be $600-$700 million in 2019 and that charges associated with the plan will be minimal after 2018. We bring this up simply because we will be skeptical if another huge plan is announced at the first of the year.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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