BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Altria (MO) – Recent/Proposed FDA Actions

We remain negative on Altria and the US tobacco market because the industry is in long-term decay and the speed is accelerating. We further believe that there are several FDA catalysts that could boost the rate of decay further and perhaps gap the number of smokers down very quickly too. The FDA has been very clear what its goals are:

1. Continue efforts to convince more current smokers to stop using cigarettes – by switching to less harmful nicotine sources to quit

2. Restrict/Remove products that make smoking harder to quit

3. Stop replacement smokers from starting by restricting access to youth

The FDA has nearly everything working according to plan with two exceptions – 1) menthol cigarettes are not experiencing the same rate of decay and are growing in market share and

2) teens and pre-teens are taking up e-cigarettes at an alarming rate which could create nicotine addiction that transitions them to smoking cigarettes too.

We noted in our report two weeks ago that, the FDA pulled several e-cigarette products and menthol cigarettes off the market. Last week it was leaked that the FDA is preparing to restrict the sale of flavored e-cigarettes in convenience stores and starting the move to ban menthol cigarettes. The plan was confirmed today and efforts are focusing heavily on preventing youth smokers. Scott Gottlieb, the head of the FDA has said that he does not want the youth of America getting addicted to nicotine, "We now have evidence that a new generation is being addicted to nicotine (via e-cigarettes), and we can't tolerate that." He said last week, "*We are going to be putting in place some additional restrictions on how these products can be sold, particularly the flavored products. That's my legal mandate, is to bring down smoking rates."*

- Tobacco companies already losing again – companies now support minimum age to purchase tobacco products at 21. All of them now support it. Only 5% of smokers start after age 21. Without new smokers replacing those who quit, the decay rate for cigarettes should accelerate.

- The menthol ban may take years, but the FDA has already concluded in 2013 that menthol makes it harder to quit and likely poses greater health risks than non-menthol cigarettes. Now the FDA is advancing rules to ban menthol cigarettes. We expect the industry to go along with many compromises to postpone a full ban. Compromises may still hurt sales too and this has been one area of non-decay for the industry.

- The numbers are on the FDA's side. They can show sales trends youth being attracted to flavored products, menthol products, and growing demand only in those areas. It is focused heavily on stopping any trend that is growing.

The Basic Tobacco Company Story

The goal is to manage the decay that everyone sees – fewer people are smoking, those that do are often smoking less frequently, and the majority of smokers want to quit. The goal is to transition people to other nicotine products that extend their lives and allows them to remain customers for a longer period of time. Combine this transition with steady price

increases to offset volume losses and maintain growing cash flow to support hefty dividends and share repurchases. As we noted two weeks ago – the price increases are no longer offsetting the volume declines at MO. Also, the company's free cash flow is only about $5.1 billion going forward now vs. a $5.3 billion dividend. There is no margin for error here.

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

Much of managing the decay involves having new smokers offset some of the volume losses. The basic statistics say that 90% of smokers begin before age 18. Every day 3,500 teens try a cigarette, and 2,100 become regular smokers. Most of the data beyond those figures focus only on smokers 18 and older so we will need to make an estimate. Simply multiplying the 2,100 figure by 365, would mean 766,000 new teen smokers emerge each year. Assuming that includes kids aged 14-17, many will still not reach 18 to be part of the older stats for 1-4 more years. It's probably conservative to then say that each year about 1.1-1.5 million of these teen smokers become part of the adult statistics

The number of total adult smokers over 18 is falling about 2-3 million per year and was 34.3 million in 2016 down from 39.8 million in 2014. The decline is net of new smokers. So, the net decline is about 4%-7% per year. But, if something disrupts the flow of new smokers by 0.5-1.0 million, suddenly the net decline becomes 2.5-4.0 million per year, which is another acceleration in the decay rate to as much as 10%. If the plan remains trying to raise prices faster than volumes decay – we believe the decay rate will accelerate even further. It would certainly price more teens out of the market and add to the problems of fewer replacement smokers.

The other part of managing the decay is Altria and others want FDA approval to sell other forms of tobacco such as e-cigarettes and heated tobacco. Thus, they have an incentive to go along with other FDA initiatives even if they will hurt the base tobacco market.

Here Comes a 21-Year Minimum Age to Buy Tobacco Products

So, 90% of smokers start before age 18. However, only 5% start after age 21. Even two-three years ago, the tobacco companies were very clear about wanting to keep the minimum age to buy cigarettes at 18. This is a big deal to the tobacco companies managing the decay plan.

As the FDA pulled products off the market in October including cigarettes and e-cigarettes from Altria and British American Tobacco, it picked up support from the companies to boost the federal minimum age to 21 for all tobacco products.

The *Winston-Salem Journal* noted on November 3, 2018, "The snowball effect on the age-21 movement for buying tobacco products has reached an acceleration point once thought unfathomable within the industry and society as a whole." The article noted how the industry had their heels dug in to protect the age-18 policy only 4 years ago.

In recent weeks, Altria, Reynolds (British American), Imperial Brands, and Juul all have come out in favor of the FDA's push to raise the minimum age to 21 for cigarettes, e-cigarettes, and other forms of tobacco. That presumably would include any heated tobacco product launch. There are already 6 states that have boosted their age: California, Hawaii, New Jersey, Maine, Oregon, and Massachusetts. In 2014, there were 40 cities with a 21-year minimum. Now, 350 cities have raised the age.

There are not many people left, who oppose this change if the companies are willing to support it now. Juul and Imperial already have a 21-year old minimum age to purchase their e-cigarette products online in effect. This could be something that becomes policy/law in a quick time-frame. Juul's CEO Kevin Burns said, "*We are committed to preventing underage use, and we want to engage with FDA, lawmakers, public health advocates and others to keep JUUL out of the hands of young people."*

Remember a federal judge already is already requiring the procedures for graphic warnings for cigarette packaging to be in place by May 2021 at the latest. These have proven to be effective around the world as preventing young people who see the pictures from starting and encourages current smokers to quit or smoke less. So here are two events moving forward to disrupt new smokers from starting. If this industry loses up to one million replacement tobacco users annually going forward, with these types of changes – the decay rate for volumes should accelerate.

The FDA's Most Recent Outlined Plans Are to Remove More Paths to Youth Smoking

Last week, the FDA reacted quickly to a surge in young people using e-cigarettes. This is what is firing up the controversy in the last year. The FDA does not want e-cigarettes becoming a gateway to youth getting addicted to nicotine and becoming future cigarette smokers:

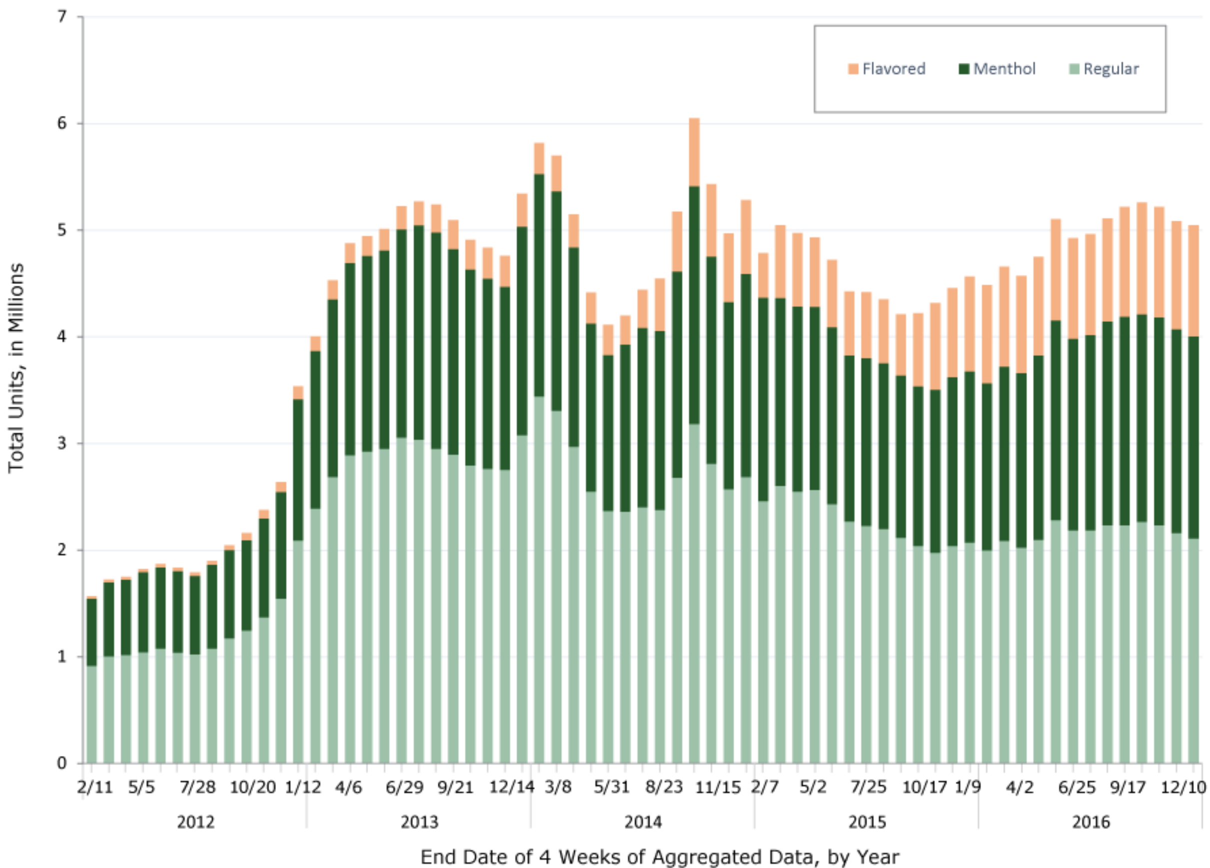
E-Cig % of Group	2017	2011
Middle School	3.3%	0.6%
High School	11.7%	1.5%

This data is also from CDC's *Morbidity and Mortality Weekly Report*. The recent data being cited by the FDA shows that e-cigarette usage by people under 21, continues to spike. We have seen numbers that usage among young people jumped anywhere from 50%-77% since 2017.

What is coming is a ban on flavored e-cigarettes sold at convenience stores and gas stations. The FDA sees age-checking as more lax in those locations. Also, there are many states with a minimum age to buy tobacco products of 18. The FDA has said that flavored e-cigarettes would still be available in specialty vape and tobacco stores for adults over 21. Scott Gotlieb noted this problem last week too, "*We are going to be putting in place some additional restrictions on how these [e-cigarette] products can be sold, particularly the flavored products.*"

The tobacco companies are going to have to choose whether to fight pulling product out of certain stores or agreeing with their new policy to support no tobacco products being sold to people under 21. The FDA can show the numbers jumping for teens using nicotine – we're not certain the companies want to be seen publicly standing against curbing that growth. There is some serious attention focused on stopping youth nicotine addiction. But, without new smokers, Altria's current dividend is not sustainable in our view. We've written quite a bit about changes in the regulations in recent months and it surprises us how rapidly they are rolling out in a negative way for the tobacco industry.

The FDA can see that flavors play a role in people buying e-cigarettes. A CDC study looked at e-cigarette retail sales from 2012-16. During that time, e-cigarettes went from about 1.6 million units to 5.0 million units. Flavored e-cigarettes went from 0% to about 20% of the market and menthol to about 40% of the market.



The FDA is also being very clear to the industry. If the Tobacco companies do not help reduce young people using e-cigarettes by limiting products and selling locations – the FDA will take further actions. Moreover, while the FDA is leaving menthol and mint flavors on e-cigarettes alone for now – it will reexamine that if the e-cigarette trends do not reverse. According to the November 15, statement, "*The FDA will not ignore data regarding the popularity of mint and menthol-flavored ENDS (e-cigarettes) among kids. We will continue to use all available surveillance resources to monitor the rates and use patterns among youth and adults for these products, and we will reconsider our policies with respect to these products, if appropriate.*"

The FDA Continues to Focus on Menthol

As part of last week's precursor on e-cigarette distribution changes, the FDA noted that would not ban menthol versions of e-cigarettes in convenience stores. It confirmed that

today in changes it is seeking for the e-cigarette market. The reasoning is they did not want people finding out there were no menthol e-cigarettes available, but regular tobacco cigarettes in menthol were available in that same store and thus opting for the more dangerous product.

However, it is still looking to restrict menthol like Canada and the EU are doing. The FDA said in 2013 that menthol increases health risks by masking the harshness of tobacco and allowing people to smoke more deeply and more often – making quitting even tougher. This week, Scott Gotlieb said, "Menthol is a significant problem."

The agency has been gathering data and support for a ban. It was announced today that the FDA will advance a Notice of Proposed Rulemaking to ban menthol in combustible tobacco products such as cigarettes. Scott Gottlieb specifically noted menthol cigarettes are unduly popular with youth smokers and "unlike menthol-flavored ENDS (e-cigarettes), there's no evidence to suggest that menthol-flavored cigarettes may play a role in harm reduction for adult smokers." It may take a few years to get it fully in place, but the writing will be on the wall as far as future cigarette sales and MO's dividend sustainability are concerned. A large part of cigarette sales will likely disappear in a few years. The tobacco companies will push back to delay this – but again the data and another case to prevent youth smoking is on the FDA's side.

FDA is Looking at Overall Smoking by Young and Old Falling

We think everyone understands by now that the number of smokers is declining. The CDC (Center for Disease Control) tracks this in its *Morbidity and Mortality Weekly Report.* They follow cigarette, cigar, e-cigarette, and smokeless tobacco trends. Here are the last three years available for the number of adult cigarette smokers over 18-years of age:

in mm's	2016	2015	2014
Adult Smokers	34.3	36.6	39.8

Youth cigarette smoking has also been on the decline. The CDC does not give a number of smokers these categories simply how many of the populations of middle school kids and high school kids have smoked cigarettes in the last 30-days:

% of Group	2017	2011
Middle School	2.1%	4.3%
High School	7.6%	15.8%

The Exception is Menthol (and E-Cigarettes as noted above)

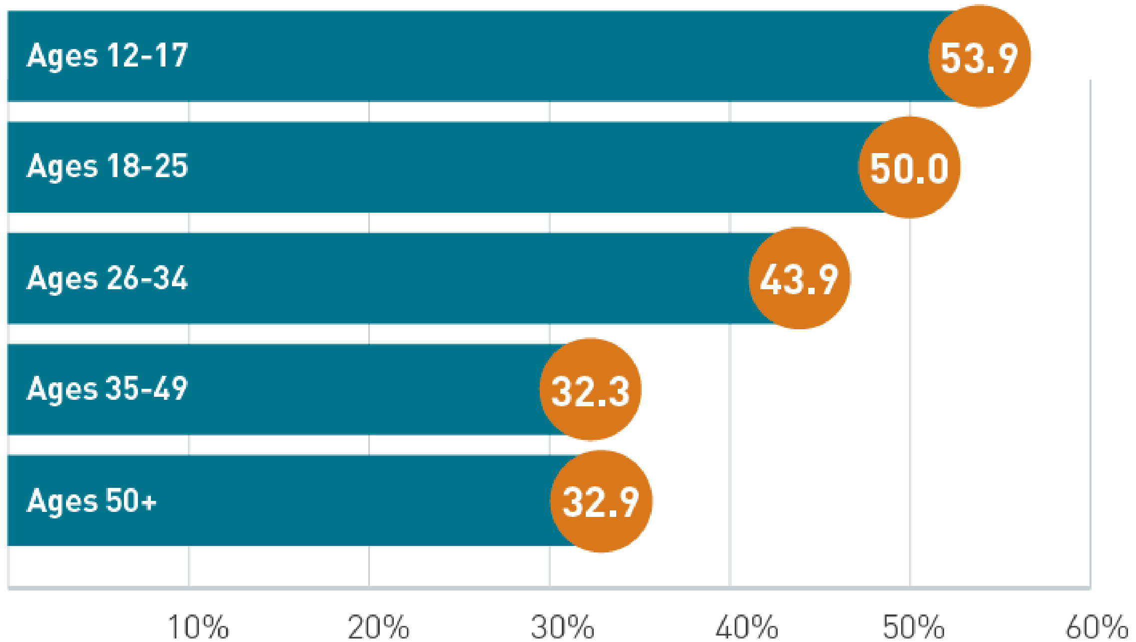
We have talked about this considerably in past reports on Altria. In basic terms, menthol is not considered addictive. However, it smooths the harshness of tobacco and can make it easier for new smokers to start and allow current smokers to inhale deeper and smoke more frequently.

We have also pointed out in past Altria reports how the volumes for cigarettes have been on a steady decline that is now accelerating again. Yet, menthol cigarettes are taking market share and, in some years, posting volume growth:

Nielsen Data	2015	2014	2013	2012
Menthol % Cigarettes	32.5%	31.9%	31.3%	30.5%
Growth in Menthol	0.5%	-0.7%	0.0%	

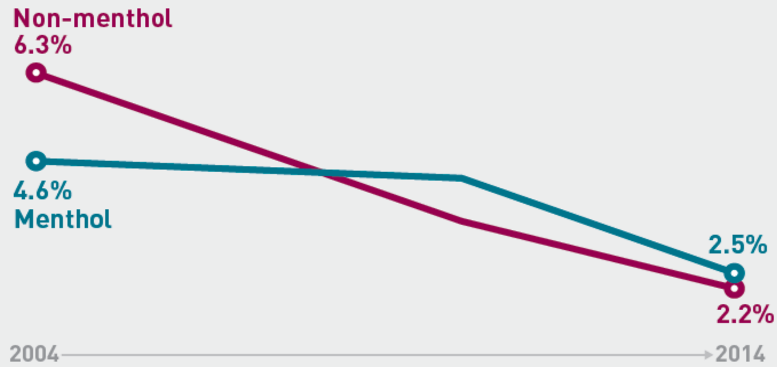
That data is from Nielsen tracking product sales. We have seen estimates that now put menthol cigarettes at 35% of the US the market. So, menthol is not following the rest of tobacco usage down like the FDA wants.

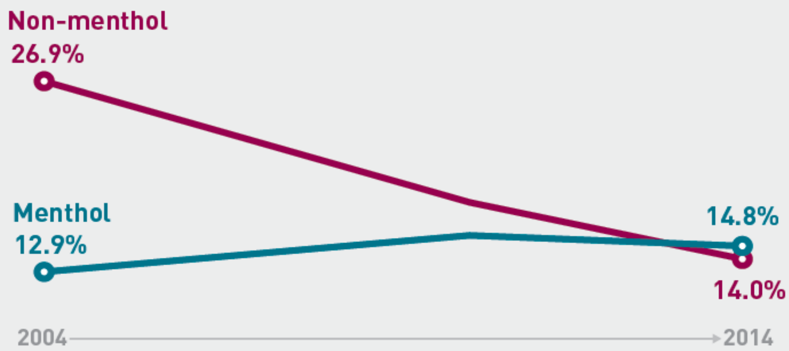
We will not cover the menthol issues again in depth, but this collection of studies and findings fact sheet will give you more of a primer. We will highlight some of the graphics showing that menthol remains very popular and non-menthol smokers are declining faster than menthol ones at all ages. If e-cigarettes are in the crosshairs of the FDA to prevent under 21-year old people from becoming addicted to nicotine, then menthol has to be addressed as well in our view:

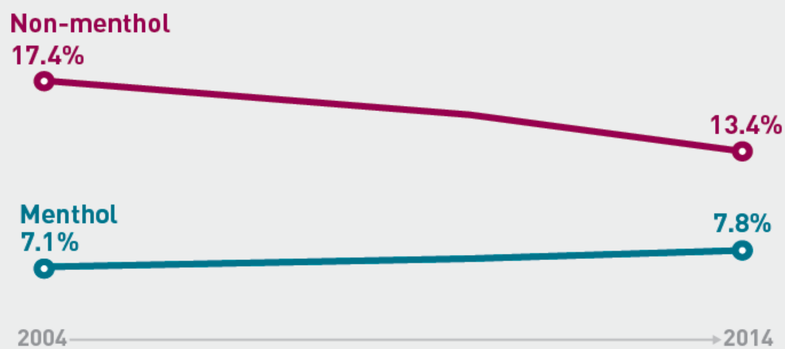


Younger smokers are more likely to use menthol cigarettes. This is how the FDA can further push for menthol bans and restrictions – to prevent youth smoking. However, even among adults, the menthol smokers are rising in terms of market percentage.

Menthol vs. non-menthol smoking rates by age, 2004-2014







Source: National Survey on Drug Use and Health, 2004–2014.

Starwood Property Trust (STWD) 3Q Update

We continue to recommend Starwood Property Trust (STWD). The company continues to diversify its operations while maintaining assets that benefit from rising interest rates. We recommend that clients read our May 24 report as a primer for why we see value here, potential for capital appreciation, and a stable 8.9% dividend.

In this report, we want to update some of the prior notes and address some changes that should be positive as well:

- STWD continues to focus on floating rate investments with fixed funding costs so rising rates help earnings. Core earnings continue to outpace dividend.
- Value of the actual real estate investments is rising via higher cash flow and actual transaction gains – book value at STWD remains understated.
- New GE Infrastructure deal adds diversity but maintains a model of investing STWD is very familiar with.
- Change in accounting for convertible debt retained capital to deploy has not hurt book value per share even with a higher share count.
- Loan provision taken in 2Q18 may result in no loss at all.

STWD Remains Positively Positioned for Rising Interest Rates

STWD buys a number of assets such as commercial mortgage debt, real estate properties, and infrastructure debt all play a role. Each of these has either floating interest rates or have rent increases tied in. 93% of commercial loans and 97% of infrastructure loans are tied to LIBOR. The result is cash flows to STWD increase as interest rates rise. It enhances this further by using fixed cost of capital when possible. If anything, this has become slightly better in the last 6 months:

LIBOR Increase	Annual EPS Change
100bp	6-cents
200bp	13-cents
300bp	21-cents

Two quarters ago, the 300bp move was 20-cents. There are two things to keep in mind with this, the first is STWD has issued shares to acquire some of its real estate and it issued shares in connection with some convertible debt in 2018. The share count rose about 5% from 1Q18 and yet the forecasted LIBOR change to EPS is gaining strength for shareholders. Second, this is a company that for years reported core EPS in the high 40-cent range against a dividend of 48-cents. The payout was above 100%. Now core EPS is consistently higher than the dividend:

	3Q18	2Q18	1Q18	4Q17	3Q17
Core EPS	$0.53	$0.54	$0.58	$0.55	$0.65
Dividend	$0.48	$0.48	$0.48	$0.48	$0.48
Payout	91%	89%	83%	87%	74%

In 3Q18, the $0.53 was negatively impacted by 2-cents for retiring debt and transaction costs for the GE acquisition. In 1Q18, there was 4-cents of positive impact from retiring debt. In 3Q17, there was a 13-cent gain. Without these items, core EPS has essentially been $0.55 for several quarters now (even with a higher share count) with a 90% payout for the dividend, which is normal for a REIT.

Compare that to the LIBOR sensitivity, and EPS could see 3%-6% growth just from interest rates rising. On top of that, rising rates makes it easier to keep money at work – it doesn't prepay or refinance as quickly. So, the commercial portfolio has grown 17% since 1Q18 with a high level of first mortgage loans and a higher unleveraged return:

$ in millions	3Q18	2Q18	1Q18	4Q17	3Q17
Portfolio Size	$7,505	$7,039	$6,889	$6,966	$6,767
% First Mortgage	87%	90%	85%	83%	82%
Unlevered Return	7.3%	7.3%	7.4%	7.2%	7.2%

Value of Real Estate Continues to Be Seen

Since STWD started to buy physical real estate it has highlighted several things:

- The timing on when a sale occurs is up to STWD unlike investing in mortgages, which can prepay at any time.

- Depreciation penalizes GAAP earnings, which allows STWD to retain more capital to reinvest rather than paying it out as dividends under REIT guidelines.

- The value of these assets is actually rising and will be reflected upon actual sales that recover cost of acquisition, recoups depreciation, and a return on top of that.

The company has focused on unique situations where they see long-term demand growth for the real estate that will boost rents, property values, and keep occupancies high. We would like to highlight three examples where the values are likely understated on the balance sheet and represent some hidden value for STWD:

The Woodstar portfolio of affordable housing apartments in Florida. STWD owns 15,000 units spread over 59 communities. We previously noted that rents were rising at 4% vs. the company's initial forecast of 2%. The units are 98% occupied. The government recently changed tax laws on affordable housing that will save STWD $6.9 million in annual property taxes. The cash on cash yield is now 11.4% vs. 10.9% and these properties are financed at a fixed 3.8% for 12-years.

The Dublin property recently saw a 37% rent increase and occupancy is 99.7%.

The Bass Sporting Goods Stores they purchased came with 23 locations and $294 million of equity was invested. They have now sold 3 locations and expect to sell 4 more in the near future. All 3 were sold at substantial gains and they expect to be at 16 units with only $130 million of equity still invested. The return has exceeded forecasts by 300bp on the IRR.

All three have produced gains in cash flow, and with Bass, have started to unlock gains that are realized into book value. The total depreciation impact from real estate on book value is $0.98 right now. Barry Sternlicht believes real-world book value here is above $20 per share rather than high $16's adjusting for market value of these investments.

The Infrastructure Unit

STWD bought this for $2.1 billion from GE in the quarter. It was a drag on 3Q18 EPS because it was only owed for 12-days in the period. It posted a loss of $6.0 million in the quarter as they recognized $6.9 million of transaction costs. This should be a unit that is accretive to earnings going forward.

This is a smaller part of STWD but keeps many of the same characteristics it looks at when investing:

- Long-term contracts with investment grade counterparties back these projects – looks very much like real estate deals
- 97% floating rate notes
- An area seeing increasing demand over many years, helps asset values
- 10%-13% IRRs forecasted by STWD
- Money stays invested – an average of 5-year loan terms
- Adds diversity – non-correlated to primary business allows flexibility to invest in better areas at all times.

STWD has experience within the company looking at these types of energy infrastructure deals and adds experience with GE employees coming over.

We will wait for some actual results like the real estate segment to emerge before fully judging this deal. On the surface, we are comfortable with it. Our knowledge of energy assets like pipelines, fractionators, power plants is they are seeing rising values in the private equity world.

Convertible Notes Accounting Change

Until June 2018, STWD's policy was that it would settle all convertible notes in cash. As a result, it did not have to account for share dilution, but it did need to record potential and paid premiums it would need to pay. For example, if the bond is convertible at $20 per share and the stock price is $21 – the bondholder has an incentive to covert the debt into stock and make a 5% return on capital. STWD would need to pay that value to avoid conversion. Thus, it would add the incremental cash payment to interest expense, which in turn would reduce book value. We noted in our May 24 issue that this lowered earnings and book value but kept share-count flat:

	1Q18	4Q17	3Q17	2Q17	1Q17
EPS Convert Impact	$0.08	$0.13	$0.15	$0.21	$0.21
Diluted Units	267.7	262.5	261.9	261.6	260.1

*The 1Q18 share bump was due to shares issued to buy the Woodstar assets

After June 30, 2018, STWD changed to a policy where it no longer asserts that it will settle all convertible notes with cash. The result is the convertible premium is no longer expensed as part of interest expense. In fact, in computing fully diluted share figures, interest expense on the convertible notes is added back to earnings but the share count reflects 100% conversion if they are dilutive.

	3Q18	4Q17
2018 Converts	$0.0	$370.0
2019 Converts	$105.9	$341.4
2023 Converts	$250.0	$250.0
	$355.9	$961.4

In March of 2018, all the 2018 convertible notes were settled in cash.

The company settled $235.5 million of the outstanding 2019 notes last quarter with 11.2 million shares and $20.8 million in cash. After the quarter, another $27.9 million was settled with 1.2 million shares and $4.7 million in cash. What remains is $78.0 million and the conversion price is $19.33 per share so they are in the money. This issue is largely resolved. What remains would be a maximum of 4.0 million shares and roughly $10-11 million in cash if they are settled with shares.

The 2023 issue converts at $25.91 and does not represent an immediate dilution issue. If they become one, the stock will have appreciated 18% - which would not be a bad thing for investors.

The share count definitely increased as a result of doing these recent settlements.

	3Q18	2Q18	1Q18	4Q17	3Q17
Shares O/S	274.1	262.4	262.0	261.4	260.8
Core Fully Diluted Shares	277.8	273.4	267.7	262.5	261.9
Adj. Book Value/Core	$17.84	$17.85	$17.74	$17.71	$17.73

But, book value per share is still rising even with the higher share count. This adds back the depreciation on real estate that should be worth more than what STWD paid.

So, why the change in policy? STWD is finding more deals to do is the easy answer and this preserves their cash for those. President Jeff DiModica noted this on the 3Q call and pointing out that STWD has $1.35 billion in available capital to deploy and a total of $4.5 billion adding in over $3 billion available on the balance sheet,

> *"After settling the bulk of our January 19th maturity convertible bonds with shares in the open window this quarter, we have capacity to execute our business plan. We also have ample unencumbered assets, allowing us the ability to opportunistically create cash, either by issuing more debt or by selling equity assets and thereby taking some of our larger embedded gains increasing our book value and earnings power going forward."*

During the quarter, the company also bought the GE Infrastructure portfolio with $2.5 billion in assets and unfunded commitments that are accretive to earnings. STWD's view would be the convertible bonds had a 5.7% effective interest rate for a few years rather than paying over 10% for a common dividend had they raised equity initially. Now, they convert to equity paying essentially 10%. However, it also becomes equity that can be leveraged against. In the words of the Chairman, "give us a dollar, and we are earning 11%-12% on it." Leverage that a little and they can make 15% against paying 10%.

Issuing 10% capital is expensive. However, the money is being put to work at a higher rate, book value is rising, and the company does have a $250 million stock repurchase plan in place – where it bought $12.1 million back last quarter.

Bad Construction Loan from 2Q May Not Result in a Loss

During the 2Q 18, STWD took a loss reserve of $22 million for a residential building in NYC. The value of the reserve involves discounting expected cash flow at the rate of the loan. The company noted that $15 million of the $22 million was the effect of discounting.

The reason for the reserve was that the developer was not selling units as quickly as forecast and would have trouble paying the loan on time. That appears to be resolving itself now:

> *Jeff DiModica on 3Q18 call:*
> *"We continue to make positive progress on our Upper West Side New York City condo loan that we discussed last quarter. As part of our recent modification to extend the loan, we were able to negotiate a recourse agreement with the borrower which should ensure we are fully filled out in 2019. Since the modification six units have already closed or are under contract."*
>
> *Barry Sternlicht added:*
> *"So, our breakeven on our loan is significantly below what they are selling, more than 50. It's 40% below what they are selling the units at right now. So, we feel very comfortable we will recover all our capital on that deal plus."*

This appears to be a situation where cash flow slowed temporarily. The value of the asset where transactions are occurring far exceeds what STWD has lent against it.

It is worth noting that there was a liquidation of a retailer tenet in Chicago that resulted in an $8.3 million impairment on subordinated mortgage loans. The unpaid balance is $12 million. Jeff DiModica added on the call, "As for credit, the LTV of our book remain consistent at 62.5% this quarter. Please note that the retail exposure in our loan book is only 2% of our portfolio and will be less than 1% in 2019"

Sysco (SYY) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	2+

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

We are raising our rating on Sysco (SYY) to 3+ (Minor Concern) from 2+ (Weak).

SYY reported EPS of $0.91 which missed consensus estimates by a penny. This is the first such miss since 2015. We suspect that some of the shortfall relative to analysts' targets could have been due to expiring non-operating tailwinds which we warned of in our 6/18 review. Given the expiration of these tailwinds, we are raising our rating to a 3+ (Minor Concern) although we remain watchful of the company's bad debt allowances. More specifically:

- We had previously warned in the 6/18 quarter that the artificial benefits from a change in stock option accounting, the exclusion of certain portions of accelerated depreciation from adjusted results, and a decline in self-insurance expense were expiring going forward. We suspect that this could have been a factor in the company missing analysts' EPS targets in the 9/18 quarter.

- Our 6/18 review also highlighted that provision for bad debt expense was a credit of $11 million in that quarter versus a $1 million expense in the year-ago quarter. Bad debt expense reversed in the 9/18 quarter and was higher than the year-ago period. Nevertheless, the allowance for bad debts as a percentage of gross receivables remains at a historically low level, leaving open the risk of higher provision expense in upcoming quarters. It worth noting that management cited two large local customers going out of business as a reason for the increase in provision expense.

Our Warning of Certain Expiring Tailwinds Has Now Passed

We pointed out to clients in our review of the 6/18 quarter that several earnings tailwinds were expiring going forward. These included:

- A 9/17 quarter change in accounting for stock options which was adding 1.5-3.0 cps per quarter to EPS growth.

- A portion of accelerated depreciation in year-ago quarters that was not being removed from adjusted EPS figures was adding about 2 cps per quarter.

- A decline in self-insurance expense of 8.5 cps for fiscal 2018 disclosed in the 6/18 10-K.

Management cited higher costs, customer mix, and Hurricane Florence as factors in the higher-than-expected expenses. We can't help but wonder if the expiration of the above benefits were a factor in the company missing earnings targets for the first time since 2015. The expiration of these benefits is the largest reason for our *EQ Review* rating upgrade to a 3+ (Minor Concern) from 2+ (Weak).

Bad Debt Allowances Remain Low

We noted in our review of the 6/18 quarter that the company's allowance for bad debt percentage was more than cut in half after the company apparently reversed $10.9 million of the reserve back into earnings. The following table shows that while provision expense normalized in the 9/18 quarter, the allowance percentage remains at very low levels:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Gross Receivables	$4,268.8	$4,099.5	$4,293.4	$4,006.2
Bad Debt Allowance	$26.4	$25.8	$65.6	$52.6
Allowance %	0.6%	0.6%	1.5%	1.3%
Provision Expense	$10.5	-$10.9	$12.2	$11.2

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Gross Receivables	$4,374.9	$4,043.5	$4,338.6	$4,012.1
Bad Debt Allowance	$41.2	$31.1	$56.5	$48.6
Allowance %	0.9%	0.8%	1.3%	1.2%
Provision Expense	$9.0	$1.4	$11.3	$4.4

While we never saw the company mention the benefit of lower bad debt expense to the 6/18 quarter, it was quick to point out that higher bad debt expense was a drag on the 9/18 quarter. Higher bad debt expense was cited in the 10-Q filing as a source of higher costs:

> *"Our operating expenses increased during the first quarter of fiscal 2019, driven by supply chain costs in both transportation and the warehouse, increased fuel costs and* ***increased bad debt expense in our U.S. Operations****."*

It was also mentioned in the 9/18 quarterly conference call as well:

> *"The increase in expense as previously discussed was largely driven by supply chain costs in both warehouse and transportation and increased fuel costs, as well as* ***increased bad debt expense in our US operations related to larger recoveries in the prior year and a couple large local customers going out of business."***

Likewise, management mentioned higher bad debt expense in the 10-Q filing for the 3/18 quarter:

> *"Our operating expense growth is primarily attributable to increased supply chain costs in both warehouse and transportation, our ongoing investment in our selling organization, specifically marketing associates, in an effort to accelerate our local sales, and* ***increased bad debt expense as a result of year-over-year comparisons to a strong prior year period."***

It is true that the company's bad debt expense jumped to a significantly higher level in the 3/17 quarter which it has so far maintained. However, based on the provision for bad debt expense shown in the table above, bad debt expense was only $1.0-$1.5 million higher year-over-year in the 9/18 and 3/18 quarters.

More importantly, the allowance for bad debt as a percentage of gross receivables remains at historically low levels. It is worth noting that management's conference call commentary we quoted above cited two large local customers going out of business as factors behind the increase in bad debt expense in the quarter. We believe the low allowance level leaves open the possibility of higher bad debt expense to shore up the reserve in future quarters.

Kraft Heinz (KHC) 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 Kraft Heinz (KHC) at 2+ (Weak)

KHC reported EPS of $0.78 in the 9/18 quarter, 3 cps below the Zack's estimate. While the company has ended its receivables securitization program, we continue to see red flags with the company's results.

- The company has completed the unwinding of both its US and international receivables securitization programs. There were no outstanding securitized receivables at the end of the 9/18 quarter, nor did the company exchange any for cash during the quarter. Adjusted accounts receivable DSOs were flat with last year, but cash flow growth will be weighed down in the next few quarters as the benefit from selling receivables is gone.

- Allowance for bad debt remained low at 1.2% of gross receivables compared to 3.0% last year. We estimate it would take $38 million (2.5cps) in charges to restore the allowance to the year-ago level.

- Accounts payable days (DSP) continue to rise year-over-year as the company extends the time it takes to pay suppliers.

Adjusted Receivables DSOs Flat Year-Over-Year

As we discussed in our 6/18 quarterly review, KHC unwound its US receivables securitization program in the 6/18 quarter, resulting in a rapid decline in receivables classified as sold. In the 9/18 quarter, it also unwound its international securitization program. As a result, there were no outstanding securitized receivables as of the end of the

9/18 quarter and the company received no cash in exchange for receivables during the period.

The following table shows accounts receivables days of sales (DSO) adjusted for the outstanding securitized balances for the last eight quarters.

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Trade Receivables	$2,032	$1,950	$1,044	$921
Reclassified as "Sold Receivables"	$0	$37	$530	$353
Receivables Exchanged for Cash	$0	$162	$659	$673
Adjusted Receivables	$2,032	$2,149	$2,233	$1,947
Sales	$6,378	$6,686	$6,304	$6,957
Adjusted DSOs	29.1	29.3	32.3	25.5

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Trade Receivables	$938	$913	$886	$769
Reclassified as "Sold Receivables"	$427	$521	$588	$129
Receivables Exchanged for Cash	$673	$579	$612	$871
Adjusted Receivables	$2,038	$2,013	$2,086	$1,769
Sales	$6,280	$6,637	$6,324	$6,857
Adjusted DSOs	29.6	27.7	30.1	23.5

While adjusted DSOs had been rising around 2 days on a year-over-year basis for the last three quarters, they were essentially flat in the 9/18 period. While we view the stability of growth in receivables as good for the quality of reported revenues, cash flow growth will be weighed down in the next few quarters as the acceleration of the collection of receivables is completely gone.

Receivables Allowance Remains Low

While the overall level and growth of receivables looks good, we do note that the company's allowances for bad debts remain less than half their year-ago levels, as shown in the following table:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Trade Receivables	$2,032	$1,950	$1,044	$921
Allowance- Applied to Trade Receivables	$24	$24	$24	$23
Gross Receivables	$2,056	$1,974	$1,068	$944
Allowance % of Gross Receivables	1.2%	1.2%	2.2%	2.4%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Trade Receivables	$938	$913	$886	$769
Allowance- Applied to Trade Receivables	$29	$28	$30	$20
Gross Receivables	$967	$941	$916	$789
Allowance % of Gross Receivables	3.0%	3.0%	3.3%	2.5%

Note that the trade receivables balances in the above table include only the amounts associated with the trade receivables that remain on the balance sheet. To put this decline in perspective, it would take about $38 million (2.5 cps) in charges to bring the allowance back up to 3% of gross receivables.

Accounts Payable Continues to Grow

We have highlighted in previous reviews that KHC's has been stretching payment terms and utilizing structured payable arrangements to boost cash flow. The following table shows the calculation of accounts payables days (DSPs) which adds back payables in structured payable arrangements that are booked in accrued liabilities to the trade accounts payable balance:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Accounts payable	$4,312	$4,326	$4,241	$4,449
Structured Payables in Accrued Liabilities	$47	$88	$141	$188
Adjusted Payables	$4,359	$4,414	$4,382	$4,637
Cost of Sales	$4,271	$4,321	$4,059	$4,200
Days Payable	93.1	93.2	98.5	100.7

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Accounts payable	$3,947	$3,888	$3,936	$3,996
Structured Payables in Accrued Liabilities	$0	$0	$0	$0
Adjusted Payables	$3,947	$3,888	$3,936	$3,996
Cost of Sales	$4,077	$4,204	$4,125	$4,398
Days Payable	88.3	84.4	87.1	82.9

We see that the year-over-year rise in DSPs continued into the 9/18 quarter.

One item that stands out is the sequential decline in structured payables in accrued liabilities. Remember that structured payable arrangements represent the company making third-party financing available to its suppliers whereby they can sell their receivables due from KHC. Consider the note on structured payables from the company's 10-Q filing:

> *"Additionally, we enter into various structured payable arrangements to facilitate supply from our vendors.* ***Balance sheet classification is based on the nature of the agreements with our various vendors.*** *For certain arrangements, we classify amounts outstanding within other current liabilities on our condensed consolidated balance sheets."*

Given that the balance sheet classification depends on the nature of the agreement, it seems that the decline in the amount of structured payables booked in accrued liabilities does not necessarily mean a reduced use of structured arrangements. Our standing concern with these rising payables balances is the question of how long the company can continue to boost cash flow growth by extending the time it takes to pay suppliers. With the company currently taking over 3 months to pay, our guess is not much longer.

Ball Corporation (BLL) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
2-	3-

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

We are lowering our rating on Ball Corporation (BLL) to a 2- (Weak) from a 3- (Minor concern.

BLL reported EPS of $0.56 in the 9/18 quarter, 4 cps short of the Zack's estimate. We are lowering our rating on BLL based on the rapid increase in receivables factoring which we believe is giving cash flow growth an unsustainable boost.

- The amount of accounts receivable sold but outstanding at the end of the 9/18 quarter rose to over $940 million from approximately $650 million a year ago. We estimate that the increased use of factoring provided the bulk of reported operating cash flow growth in the period which was already benefitting from $150 million in lower cash pension contribution.

- Accounts receivable days (DSOs) rose by 2 days after adjustment for sold receivables.

- Accounts payable continue to rise year-over-year as days payable jumped by 18 days over last year's third quarter. However, the sequential increase is leveling out and the boost to cash flow growth from extending payment terms appears to have reversed.

Receivables Factoring Continues to Expand

BLL continues to sell off receivables at an accelerating pace. While the company does not disclose the exact amount of sold receivables that are still outstanding at the end of the period, it does tell us the current limit of the factoring facility and the amount available for sale at the end of the quarter. This is the company's latest disclosure on the matter from its 10-Q filing for the 9/18 quarter:

"We have entered into several regional committed and uncommitted accounts receivable factoring programs with various financial institutions for certain of our receivables. The programs are accounted for as true sales of the receivables, without recourse to Ball, and had combined limits of approximately $1.15 billion and $1.0 billion at September 30, 2018, and December 31, 2017, respectively. A total of $208 million and $439 million were available for sale under such programs as of September 30, 2018, and December 31, 2017, respectively."

We arrive at an estimate of the amount of outstanding sold receivables by taking the difference between the facility limit and the amount still available for sale. The results are shown in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Limit of Factoring Facility	$1,150	$977	$800	$1,000
Available for Sale	$208	$139	$211	$439
Implied Amount Sold and Outstanding	$942	$838	$589	$561

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Limit of Factoring Facility	$1,000	$1,000	$865	$970
Available for Sale	$354	$342	$323	$374
Implied Amount Sold and Outstanding	$646	$658	$542	$596

We noted in our review of the 6/18 quarter that there was a noticeable jump in outstanding sold receivables. This increase accelerated in the 9/18 period as estimated outstanding sold receivables jumped by almost $300 million (>45%) over last year's third quarter. Reported operating cash flow would have received a tremendous boost from the acceleration of the collection of these receivables. We will discuss that more in the next section.

Adjusted DSOs Up Almost Two Days

As noted in the previous section, BLL appears to be rapidly expanding the use of its receivables factoring program. When the company sells receivables, they are treated as a sale with no recourse and the receivables are removed from the balance sheet altogether. This understates the reported receivable days of sales (DSO) calculation, so we must add back those outstanding sold amounts to the reported balance sheet amounts to get a clearer picture of trends in the company's revenue recognition. We show this exercise in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales Under Pre-606 Accounting Method	$2,985	$3,143	$2,752	$2,747
Receivables Under Pre-606 Accounting Method	$1,622	$1,722	$1,745	$1,634
Balance Sheet Receivables	$1,622	$1,800*	$1,745	$1,634
Pre-606 Balance Sheet DSOs	49.6	52.3	57.9	54.3
Receivables Sold and Outstanding	$942	$838	$589	$561
Adjusted Receivables	$2,564	$2,638	$2,334	$2,195
Adjusted DSOs	**78.4**	**76.6**	**77.4**	**72.9**

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales Under Pre-606 Accounting Method	$2,908	$2,855	$2,473	$2,523
Receivables Under Pre-606 Accounting Method	$1,793	$1,637	$1,695	$1,491
Balance Sheet Receivables	$1,793	$1,637	$1,695	$1,491
Pre-606 Balance Sheet DSOs	56.3	52.3	62.5	53.9
Receivables Sold and Outstanding	$646	$658	$542	$596
Adjusted Receivables	$2,439	$2,295	$2,237	$2,087
Adjusted DSOs	**76.5**	**73.4**	**82.5**	**75.5**

*includes $78 million of receivables that were held for sale

Note that the company adopted ASC 606 revenue recognition method at the beginning of the year. The above revenue and receivables for 2018 periods are restated to conform with the pre-606 method to be compatible with prior periods.

We see that DSOs calculated using the receivables reported on the balance sheet fell dramatically from 56.3 in the 9/17 quarter to 49.6 in the 9/18 quarter. However, this was a direct result of the company accelerating the sale of receivables as we discussed in the previous section. If we add back the estimated outstanding sold receivables, we get a much different picture. Adjusted DSOs rose to 78.4 from 76.5 a year ago. This is not an alarming increase by itself and we are not currently concerned that the company is boosting sales by aggressively offering more generous payment terms. However, let's look at how much the acceleration in receivables sales is boosting cash flow.

According to the above table, outstanding sold receivables increased by $381 million ($942m-$561m) during the first nine months of the year. This represents cash the company would not have collected during that period if it had not sold off the receivables. Also, consider that BLL reported $1.027 billion of operating cash flow and $411 million of free cash flow during the same period.

Further, let's compare the increase in cash generated by increased receivable sales to the year-ago period. During the first nine months of 2017, outstanding sold receivables

increased by $50 million ($646m-$596m). This means that reported operating cash flow growth during the nine months ended 9/18 received a $331 million tailwind ($381m-$50m) from the increased rate of receivable sales. Consider that reported operating cash flow growth during the period was only $283 million, which implies that operating cash flow would have declined during in the first nine months of 2018 without the accelerated pace of receivables factoring. We understand that there are other factors impacting BLL's cash flow growth during the period including higher cash tax payments. However, cash flow also benefitted by a $148 million decline in cash pension contributions as well. It is clear that the receivables factoring program is having a major impact on the company's reported cash flow growth during the past year that may be giving investors a false picture of its true strength.

Days Payable (DSP) Continues to Climb YOY, But Are Leveling Off

We pointed out in our review of the 6/18 quarter that BLL's accounts payable balance has grown rapidly in the last several quarters. This trend continued into the 9/18 period as seen in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS Under Pre 606	$2,393	$2,522	$2,206	$2,134
Accounts Payable	$2,953	$2,937*	$2,822	$2,762
Adjusted Days Payable	112.6	106.3	116.7	118.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS Under Pre 606	$2,338	$2,270	$1,975	$2,009
Accounts Payable	$2,419	$2,146	$1,830	$2,033
Adjusted Days Payable	94.4	86.3	84.6	92.3

*Includes $198 million of payables classified as held for sale

While days payable (DSP) are still climbing on a year-over-year basis, the sequential growth has levelled out. Consider that payables at 9/18 increased by $191 million since the beginning of the year while they increased by $386 million in the comparable year-ago period. This is not a surprise given that the time the company was taking to pay suppliers had jumped to over 100 days. However, it highlights that a boost to cash flow growth is now turning the other direction.

Explanation of EQ Rating Scale

Rating	Explanation
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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