BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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American Tower Corp. (AMT)- Initiate with NEUTRAL

AMT is a company that appears to have a simple business model with highly predictable results backed by long-term leases with customers. With its REIT structure, it saves on income taxes and pays a 2% dividend that has been growing at 20%. Given that growth rate and the basic results, we think many income investors own this stock. Looking at the debt situation and the cash flows available for shareholders, we do not think 20% dividend growth can be maintained much longer. Fast growth simply relies too heavily on acquisitions, which requires more borrowing and the focus on deals has been overseas where the new cash flow tends to stay.

In many areas, we believe the company's accounting is more conservative than similar types of companies we have seen over the years. We still think investors should be aware of headwinds and lower flexibility that can impact AMT. These are unlikely to derail AMT's operations or the dividend but may crimp its ability to grow the dividend at the rapid pace it has seen recently. We are neutral on this stock.

- Steady growth comes from adding more systems to the same tower (called colocation) and it drives growth at just under 5% at AMT. Price increases are offset by churn but come in steadily at just under 2%.

- Bigger growth requires acquisitions or building more towers and FX to not pull down results. The only way AMT can pay for the former is to borrow money. FX is a wildcard but is more likely a drag given many emerging markets where it operates.

- Reported AFFO to the dividend provides a solid cushion and makes more dividend growth appear easy to achieve.

- Maintenance capital spending and investments in colocation appear higher than what AMT is reporting in AFFO. We think this could lower AFFO by at least $200 million.

- If they don't spend that money and colocation growth doesn't happen, they may see some large intangible assets become impaired which could rapidly cut book value.

- Income taxes overseas appears to be a headwind to AFFO and recent actions will reduce rents on some towers in India by 80%.

- A put option to acquire the remaining Indian partner's minority assets for $400 million has been triggered. That is a cash outflow. There are some troubles for the counterparty in Africa too.

- AMT's debt at 5.0x EBITDA is already steep and nearly all of it is in US dollars.

- Investors should be aware that 35% of operating profits come from overseas and much of that cash flow is staying there. That effectively lowers the surplus EBITDA in that debt-to-EBITDA ratio and it also effectively reduces AFFO for the dividends.

- Some debt is floating rate and 10%-20% rolls over annually, which gives AMT a headwind from rising interest expense that could penalize AFFO more.

Basic Overview of the Operating Model:

AMT gets 99% of its revenues by leasing its towers. These leases are typically greater than 10-years in length with renewal options. Often, they include a rent escalator. There are really only three ways AMT grows:

- Acquire or build new towers

- Add new customers to existing towers or have existing customers add new services to towers – (think operating a 3G network and then adding 4G and now 5G).

- Boost rent with price increases

When we look at the recent results, it is clear that a huge part of growth is coming via acquisition and new construction. The addition of more equipment per tower is a steady area for 4%-5% annual growth. The price increases are net of customer churn that normally runs about 2%. In 2018, India has seen customer consolidation that resulted in heavy churn and drove the escalators to 0%. Had India not seen this, the rate in 2018 would be about 1.7%, within the recent normal range.

	YTD 2018	2017	2016	2015
Property Rev.	$5,211	$6,566	$5,713	$4,680
Y/Y Growth	6.6%	14.9%	22.1%	16.8%
Key Parts				
Acq/New Build	2.6%	6.5%	17.5%	13.2%
Colocation	4.5%	4.7%	4.5%	5.4%
Escalators/Churn	0.0%	1.3%	2.0%	1.4%
FX impact	-1.9%	0.8%	-3.9%	-8.5%

Basic growth here is about 6%-7% without acquisitions and adding new towers with a wildcard from FX. Given that the foreign markets include: India, Brazil, Argentina, Chile, Mexico, Ghana, South Africa, Uganda, and Nigeria – odds are high that FX will be a wildcard in most years in our view. Acquisitions and new building require hefty capital

spending. Colocation can require that too if a tower needs to be modified or increased in size. AMT has been a heavy borrower:

	YTD 2018	2017	2016	2015
Cash Ops	$2,485.1	$2,925.6	$2,701.7	$2,166.9
Cap Exp.	$610.4	$803.6	$682.5	$728.8
Acquisitions	$1,437.8	$2,007.0	$1,416.0	$7,020.6
Free Cash	$436.9	$115.0	$603.2	-$5,582.5
Dividends	$994.0	$1,164.4	$993.2	$797.5
Repurchases	$181.2	$766.3	$0.0	$0.0

In 2018, the company converted the preferred stock to common, the dividends reflect the payment on both preferred and common. The company is not covering the dividend from earnings. However, the depreciation figure is so high and acts as a drag on earnings and far exceeds capital spending, we are less concerned about the dividend to earnings ratio at essentially 100% in 2018 and 95% in 2017. AMT will argue that AFFO (Adjusted Funds from Operations) which deducts maintenance capital spending (that's a huge plus in our opinion – kudos to AMT), is a better measure. They see maintenance capital spending at about $110-$140 million per year and AFFO at $2.8-$3.0 billion net of that spending. The current dividend is $1.4 billion giving them roughly a 50% payout of recurring cash flow.

We will also address Return on Capital. Again, based on operating earnings after deducting the depreciation – ROI is only about 8% in most years. However, using AFFO, which adds back the depreciation net of maintenance spending, and interest expense of that is currently about $840 million per year the numerator becomes $3.6-$3.8 billion. Total capital is $26.7 billion thus making return on capital about 14%.

Cash Needs for Maintenance Cap-Ex May Be Higher than Expected

In looking at AFFO, we have ripped other companies like Welltower for not including maintenance capital spending in their calculations. AMT does add this in, but we think it is too low. The gross amount of PP&E is essentially $17 billion. AFFO has only about $110-$140 million as capital spending. Still leaving out acquisitions and discretionary capital spending to develop new towers and tower sites, here is what else AMT has in capital spending:

	2017	2016	2015
Redevelopment	$138.8	$136.8	$114.1
Capital Improvements	$65.6	$81.8	$42.4
Regional Improvements	$106.4	$139.4	$201.1
Total	$310.8	$358.0	$357.6
Reported in AFFO	$131.2	$126.6	$106.3
Difference	$179.6	$231.4	$251.3

Redevelopment relates to colocation efforts to boost capacity at existing sites. We consider this part keeping the asset attractive to existing customers to use it in the future as it builds out new networks. Otherwise, those networks go elsewhere. These represent the same customer base AMT has in many cases. Capital Improvements enhance existing sites for functionality and capacity – the technology changes. Regional improvements help towers in an area increase coverage and functionality. If the base growth figure for AMT without acquisitions is essentially 1.5%-2.0% in price hikes and 4.5%-5.0% colocation to reach 6%-7% then we believe these capital spending figures should not be considered discretionary.

Acquired Network Intangibles

This is one of the stranger accounts we have seen. When AMT makes acquisitions and allocates the purchase price – it records fair market value to PP&E and other assets. One of these other assets is Acquired Network Intangibles. This represents the value of potential revenue growth from selling additional space on acquired towers to new customers or existing customers who are expanding their services. That doesn't mean that new revenue will be realized – just that the company intends to work to achieve it via colocation that we talked about earlier as one of AMT's three sources of growth.

First off, we will again say this item is a conservative way to account for acquisitions. AMT assigned $4.8 billion to this account and is amortizing it over up to 20 years against earnings. It's more conservative because they could have just put it in goodwill and not amortized it all and thus boosted earnings. As a REIT, and having to pay out 90% of earnings, having this amortization lower income is probably a good way to retain some capital.

Second, this is another reason to record more capital spending against AFFO. The company has already highlighted that it is investing in this area to sign more business. Without that spending, they may not get as much colocation business as planned. In that case, the future

cash flows - that are supporting the intangible asset value for Acquired Network Intangibles – come in low and cause write-downs in that asset. That's potentially a big number. This account is at $3.2 billion in value vs. AMT's equity balance of $5.4 billion.

Potentially this may also have some ties to the other big intangible, Acquired Tenant Intangibles at $8.2 billion. That would relate to the value of existing customers who are also the most likely to be colocation clients. Much of the colocation would involve adding the next generation equipment to the same tower and keeping the older generation active as well. So, the property has to meet the client's current and future needs. Plus, we do not view colocation as something that grows forever – there still is only so much space on a tower to sell.

So, while AMT is using a more conservative form of acquisition accounting, it likely does require higher amounts of recurring capital spending to protect against impairments that could have a large impact on the equity value.

Income Taxes May Be Rising

The REIT status of AMT removes the vast amount of income tax that a standard C-Corporation would pay in the US. However, its foreign operations have become larger and they do pay income tax overseas. AFFO starts with net income which deducts income taxes. It then adds or subtracts the change in deferred taxes to determine the cash impact of taxes. AMT's data here is well laid out and the numbers match:

	2017	2016	2015
Income Taxes	$30.7	$155.5	$158.0
Change in Deferred	-$105.8	$59.2	$1.0
Tax Impact on AFFO	$136.5	$96.3	$157.0
Cash paid for taxes	$136.5	$96.2	$157.1

AFFO thus takes into account the cash impact of income taxes. We have no problem with this procedure.

We believe that the income taxes will rise simply as the foreign operations mature. In 2017, the company noted that 44% of revenue was in foreign currency but 51% of expenses were in foreign currency. We are not going to look at this as transaction splitting where a

company reports more expense in a high tax area and more revenue in the low tax area. It looks simply like there have been more set up costs overseas initially and management is signing contracts and the company is doing more work in other markets. If the company's operations are largely passive once an asset is in place – essentially build a tower, sign a contract, collect rent for 20-years – we would expect the revenue overseas to rise and the costs decline. That would create more foreign income which is taxed. The percentage of income and assets overseas is rising:

	US PPE	Non-US PPE	US Rev	Non-US Rev	US Op. Inc.	Non-US Op. Inc.
2017	59%	41%	56%	44%	65%	35%
2016	63%	37%	60%	40%	68%	32%

We also noted that AMT has taken several impairment charges in India totaling $360 million during 2017 and 2018. These stem from a customer bankruptcy, another customer boosting churn as it consolidates tower sites, and write-downs of equipment. The ultimate view is that these assets will still be used and gain more customers as new networks are rolled out and the churn slows. If this works, depreciation on these assets will be lower and thus income higher creating more income taxes in the future.

After 3Q, some more news came in on the Indian assets:

> *"Tata Teleservices Agreements—On October 23, 2018, the Company entered into agreements with Tata Teleservices and related entities for a settlement and release of certain contractual lease obligations effective November 1, 2018. As part of the arrangement,* ***the Company will receive an upfront one-time INR denominated cash payment equal to approximately $320.0*** *million for the termination of lease obligations with Tata Teleservices in India. In addition,* ***the Company entered into new leasing arrangements with a number of Tata-affiliated entities. The Company expects the net impact of these two transactions to represent an approximate 80% reduction in the contracted tenant revenues generated from the terminated leases.*** *In connection with the acceleration of the contractual arrangements, the Company will also revise the amortization of its tenant-related intangible asset with Tata Teleservices."*

So, here comes a $320 million cash payment to terminate leases, which could generate taxes. However, offsetting that is another write-down in asset values coming to reflect lower lease revenue overall. There is also a tax dispute in India for $70 million that the company has

won, but the government is appealing. More importantly, India is normally about 10% of AMT's operating income at roughly $400 million. We do not have enough information to evaluate the Tata 80% reduction in rent on terminated leases, but this should be another hit to AFFO.

There are several moving parts to this and taxes are not a major cash expense for AMT. However, many signs point to cash taxes rising in the future.

Minority Interest Put Options Trigger More Cash Payments

Several of the foreign operations at AMT are owned jointly with other companies. Their Indian operations have a put option that allows the minority interest parties to sell their remaining investments to AMT. They exercised this right and will cost AMT $400 million to add to its Indian assets:

> *"Tata Teleservices delivered to the Company notice of exercise of their put options under the Shareholders Agreement with respect to 50% of their combined holdings with Tata Sons of ATC TIPL. Additionally, IDFC delivered notice to the Company of exercise of its put option under the Shareholders Agreement with respect of 100% of its holdings of ATC TIPL. The Company expects to complete the redemption of the put shares, subject to regulatory approval, for total consideration of INR 29.4 billion (approximately $400.0 million) in the first quarter of 2019."*

In addition to India, AMT has a 49% minority interest partner in Ghana and Uganda called MTN Group. We do not know everything about MTN other than it provides cell phone service in Africa – about 1/3 of the EBITDA is from South Africa and they have had several problems with Nigeria. They are on negative watch with Moody's now. They have cut their dividend to focus on debt reduction and FX can play a negative role in their operations of dealing with emerging market currencies. Iranian sanctions make it tougher to access cash flow from there as well. There is not a put option here, but MTN has shown that there are some difficulties to operating in Africa. If it does need some help, it may be possible that AMT gets more involved here. This is purely speculation on our part of a potential wild card cash need.

Issues with AMT's Debt

AMT is carrying 5.0x Debt to EBITDA on a trailing twelve months basis ($21.3 billion/$4.3 billion). That is fairly steep in our view but is below the covenants on the bank lines. The company has to maintain total debt to EBITDA below 6.0x. The company could still borrow $5.1 billion at the end of September or see EBITDA fall by $0.9 billion and remain in compliance. Those are both greater than 20% moves.

We still see issues here, starting with the foreign operations again. Of the $21.3 billion owed, only $622.2 million is in foreign currency at the subsidiary level or basically 3%. With over 35% of the operating profit coming from overseas – this sets up some issues to explore. First, AMT funds the foreign units with intercompany notes. The company says several times in its 10-K and 10-Qs that it does not repatriate cash other than servicing intercompany notes:

> *"While certain subsidiaries may pay us interest or principal on intercompany debt, it has not been our practice to repatriate earnings from our foreign subsidiaries primarily due to our ongoing expansion efforts and related capital needs. However, in the event that we do repatriate any funds, we may be required to accrue and pay taxes."*

> *"The Tax Act requires a mandatory one-time inclusion of accumulated earnings of foreign subsidiaries, and as a result, all previously unremitted earnings for which no U.S. deferred tax liability had been accrued have now been included in the calculation of U.S. taxable income. Notwithstanding the inclusion of these amounts in the determination of U.S. taxable income, the Company intends to continue to invest these foreign earnings indefinitely outside of the U.S. and does not expect to incur any significant, additional taxes, primarily withholding taxes, related to such amounts."*

So, if the bulk of the cash flow from overseas never comes back is it really available to service the debt? Furthermore, could it ever quickly be brought back, much of it would be reinvested into fixed assets. At the end of September, AMT noted it had $1,026 million in cash with $899 million overseas. Of that $899 million, $340 million was in JVs where the partners may have some say in how that cash is allocated. They clearly are not bringing the cash flow back to pay for dividends or stock repurchases or US capital spending. AMT rolls over

much of its debt so the cash does not even need to come back to fully fund principal payments on intercompany notes as those notes could be rolled over too.

AMT breaks out operating income but not EBITDA or AFFO by geography. But we know about 35% of operating profit comes from overseas. If that percentage roughly translates to EBITDA, what if one-third of foreign EBITDA is not available, that's about $500 million of EBITDA. Now debt to EBITDA effectively becomes 5.6x instead ($21.3 billion / $3.8 billion). On AFFO that is about $2.8-$3.0 billion and that already factors in the interest expense. If foreign operations are not sending over any additional part of the AFFO, that may reduce AFFO available for stockholders by almost $1.0 billion. Now, the dividend of $1.4 billion doesn't have nearly the same level of cushion and share repurchases from internal cash may not be possible at all. Moreover, there's very little free cash flow to retire debt. Thus, we would argue that this foreign set-up effectively makes the debt load more onerous and the lowers the cash flow available.

There is obviously an FX risk too. They are getting paid in foreign currencies and paying debt dominated in dollars. The company quantified this risk:

> *"As of September 30, 2018, we have incurred intercompany debt that is not considered to be permanently reinvested and similar unaffiliated balances that were denominated in a currency other than the functional currency of the subsidiary in which it is recorded. As this debt had not been designated as being a long-term investment in nature, any changes in the foreign currency exchange rates will result in unrealized gains or losses, which will be included in our determination of net income.* ***An adverse change of 10% in the underlying exchange rates of our unsettled intercompany debt and similar unaffiliated balances would result in $116.3 million of unrealized losses*** *that would be included in Other expense in our consolidated statements of operations for the nine months ended September 30, 2018."*

AMT also securitized future rent payments on thousands of towers for some of its debt. This is $2.7 billion of the $21.3 billion in debt. These securitizations have first priority for all the cash flow generated by the specific towers. The cash flow to debt service needs must exceed 1.3x. AMT has not been in danger of breaching that test. It was over 8x and 12x on the various debt issues at the end of 2017. When the company passes the coverage tests it can access the excess cash flow for its general corporate purposes. We are less concerned about this than accessing the foreign subsidiary cash but is another minor risk factor that AMT may not always be able to fully access its domestic cash flow either.

We also believe rising interest rates are a threat as well. Generally, AMT is rolling over $2-$4 billion of debt annually and prepaying some other notes. Of their $21.3 billion in debt, $4.4 billion is variable rate. Interest expense is running about $840 million annualizing 3Q18's figure. If every year 30% of the debt is subject to higher rates, the interest expense could start to rise. Every 20bp move in interest rates for 30% of the debt adds $13 million to annual interest expense. This could also be a headwind for AFFO for the stock.

Our overall conclusion with the debt is it is not a flexible as it appears on the surface and could effectively be more onerous when factoring in that not all the cash flow is available to service the debt. The cost of funding could be rising and the fact that the company has already tapped some less than straightforward financings such as securitizing future cash flows also point to falling flexibility with the debt. Since this company's primary source of growth is acquisitions and new construction, which it pays for with debt, future growth could be trickier at achieve.

Conclusion:

There are some minor issues +/- here such as many prior acquisitions had AMT prepay for the annual land rights for towers – so that rent is amortized now as non-cash and adds to AFFO. The company also uses a small amount of capital leases and only in the interest expense impacts operating cash flow - the principal payments would appear in the financing section and thus inflate free cash flow.

There are not many near-term accounting issues here. We do think investors should be adjusting AFFO down for more capital spending of about $200 million per year as the cost of maintaining the asset base appears to be at least that much higher than reported in AFFO now. We also think investors should be reducing AFFO by some amount of foreign cash flow that is not available to cover dividends and other shareholder payments as the company does not repatriate the cash. That could be as high as another $0.8-$1.0 billion of AFFO. Taken together, that the $1.4 billion in dividends is being covered by $1.6-$2.0 billion in funds vs. the reported $2.8-$3.0 billion. We have a tougher time expecting 20% dividend growth to last much longer.

It is also difficult to overlook that the biggest source of growth here is acquisitions and the way AMT pays for that is with debt. We see several issues with the debt already such as rising interest rates and less flexibility than it appears given that a large percentage of

foreign cash flow is not fully available to support the debt. They can pull more cash back if absolutely necessary subject to FX and taxation risks. That's not to say this company cannot grow – just be aware of the already high debt level and flexibility issues.

Also, be aware that FX is normally a drag on growth – given that the markets include Uganda, Argentina, Ghana, et al, we would expect this to be a common negative wildcard for AMT. Also, while we don't fear counterparty risk much from AT&T, Verizon, or Vodafone – the Indian assets have already had some sizeable renegotiation and JV partners exercised a $400 million put option for AMT to pay. Does MTN Group in Africa have similar potential for a cash call?

GameStop (GME) Update

GameStop does not announce earnings and have the conference call until after we publish today. However, it did announce that it sold the Spring Mobile unit for $700 million. With the sale of the Cricket stores in January, this should end the company's diversification attempts into selling phones.

We noted in our report that the history of this division has been very poor after spending considerable money on it. The ROI was historically between 3%-8%. GameStop also took a $329 million impairment in fiscal 2017 along with a $33 million write-down in goodwill. After those write-downs, we would be leery of the company announcing anything other than a loss on the sale of Spring Mobile. They built this division largely with acquisitions. In August 2016, they paid $425.5 million for 436 stores or $976,000 per unit. In May of 2016, they paid $47 million for 71 stores or $662,000 per unit.

In January 2018, GameStop sold 63 Cricket stores for $3.8 million or $60,000 per unit. And now, the remaining 1,289 stores were sold for $700 million or $543,000 per unit. Figures like that would indicate to us that they lost money on this deal. The sale also comes AFTER they negotiated better terms for higher commissions and more compensation in higher-cost markets with AT&T. That may have helped boost the price of the sale.

On the positive side of this, bringing in $700 million will more than cover the $350 million in bonds due in October 2019. Also, the company still has an outstanding tax dispute in France for €80 million. It reserved just under $30 million for it recently, but this cash would now fully fund that. There would remain one other bond issue outstanding for $475 million due in 2021.

Also, on the positive side, GameStop gets rid of a non-core unit that was posting weak results. EBITDA with impairments added back was running about $75-$80 million for the technology brands unit with is largely Spring Mobile. It was spending about $20-$30 million on capital investments in this unit so net cash flow was about $50 million. Paying off the 5.5% 2019 bonds will save about $19 million. Can they earn over 9% on the remaining $350 million? If so, it would be a wash except the company would owe less money and have a weak division gone. The current dividend is $1.52 per share, which is about $1.92 pretax. Buying back 10 million shares at $15 would save $19.2 million in cash outflow and generate a return of about 13%. The company would still have $150 million in cash.

We're not advocating they buy that much stock back given the nature of other business trends at the company. However, we think it is possible to envision ways to have GameStop's balance sheet and cash flow situation improve as a result of selling the Spring Mobile unit.

Ocean Yield (OCY NO, OYIEF) Update

As noted after last quarter's earnings, one of Ocean Yield's charter customers, Solstad, is looking to negotiate better terms with creditors and ship charter partners to add liquidity for 2019. Solstad was formed by large marine-asset investors Aker and Hemen merging Solstad, Rem Offshore, Farstad, and Deep Sea Supply. The goal was to recapitalize all these companies suffering from excessive debt and too many ships in a downturn for off-shore oil drilling and production. All parties now agree that the market is starting to turn for the better, but they were too early in thinking the large merger and recapitalization deals would get Solstad fully out of all trouble. The company has announced the sale of one vessel and four new charter contracts in the last month.

Aker owns 20% of Solstad and also owns 62% of Ocean Yield. Hemen owns 16% of Solstad and 26% of Ship Finance. We noted that Ocean Yield already reworked terms of its charters with Solstad for the Far Statesman and Far Senator in early 2017. Both ships are on sub-charter now but will be free in early 2019. Ship Finance announced in its 3Q18 call that it has also reworked charters with Solstad:

> ***"Ship Finance also has five offshore support vessels on long-term charters to a non-recourse subsidiary of Solstad Offshore ASA.*** *The market for offshore support vessels remains challenging and the vessels are currently not employed on sub-charters. In light of the depressed market,* ***the company and other financial creditors entered into restructuring agreement in July where we will receive 50% of the agreed charter hire for the two vessels, Sea Cheetah and Sea Jaguar, until the end of 2019. All other payments under the respective charters will be deferred until the end of 2019.***
> *The offshore support vessels only represent approximately 2% of our charter backlog and our financial commitments is limited to a corporate guarantee of $30 million under the related bank financing of the five vessels."*

Solstad announced it reached a deal to create liquidity in July with the creditors of its subsidiary Solship Invest 3. This is the former Deep Sea Supply unit and that is where Hemen and Ship Finance were largely focused.

It is important to note that the various subs of Solstad do not have parent company guarantees and are financially independent. One of the other units here is Farstad Shipping AS – which is where the two Ocean Yield vessels are chartered. One of the issues noted in

3Q18's results for Solstad is that a large portion of Farstad Shipping debt is classified as current because of the unit breaching financial covenants.

There have been no updates on where negotiations are at this point. It seems likely that a similar plan will be proposed on the other units of Solstad like the one already reached with Solship Invest 3. That would be deferred charter payments and debt principal payments for part or all of 2019. There are deep pockets involved here from investors who have large stakes in both Solstad, Ocean Yield, and Ship Finance and generate large dividend income from Ocean Yield and Ship Finance.

We would not be surprised if Ocean Yield sees cash flow impaired in 2019 with lower payments from Solstad. It could defer the full $8.8 million in charter fees next year. That does not appear to be a problem in sustaining the current dividend at Ocean Yield. We noted that EBITDA should come in about $300 million – this would make it closer to $290 million if the deferral happens. There is essentially $250 million in cash at Ocean Yield and cash needs including the dividend will be about $400 million from September 2018 – September 2019.

We still consider resolving the FPSO vessel at Ocean Yield a bigger catalyst for 2019. While we are concerned with the outcome of Solstad's creditor negotiations, if the Ship Finance negotiation provides a map for a future result, this may not be a crushing blow.

Stryker (SYK)EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	4-

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

We are lowering our rating on Stryker (SYK) to 3- (Minor Concern) from 4- (Acceptable.)

- Contract liabilities (deferred revenue) continued to decline sequentially, falling by $56 million from the 6/18 quarter. While we still do not have a year-over-year number to compare to, such a sharp decline is always a concern as it could be an indication that there was an unusual acceleration of the recognition of deferred revenue in the quarter.

- Inventory has been growing faster than sales for the last several quarters as the company is at the beginning of a new product cycle which requires a buildout of new inventory. However, inventory DSIs are now well over 200 days and we will be concerned if we do not see inventory growth fall back in line in upcoming quarters.

It is worth noting that our cut in rating to a 3- rather than a 3+ does not indicate a large increase in our concern level but rather an indicates that there was a deterioration in our view of the earnings quality in the quarter.

Contract Liabilities Continue to Trend Down

We noted in our review of the 6/18 quarter that SYK's contract liabilities (deferred revenue) were lower in the 6/18 quarter than the 12/17 quarter. This is a new disclosure related to ASC 606, so we still do not have a year-over-year comparison. However, the sequential decline in contract liabilities continued into the 9/18 quarter:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Contract Liabilities	$281	$337	NA	$381

Consider SYK's explanation of its contract liabilities in its 10-Q filings:

> *"Our contract liabilities arise as a result of unearned revenue received from customers at inception of contracts for certain businesses or where the timing of billing for services precedes satisfaction of our performance obligations. We generally satisfy performance obligations within one year from the contract inception date."*

The company's explanation of its revenue recognition policies indicates that revenues are generally recognized when a purchase order has been received and control has transferred for almost all of its product lines. However, it states the following with regard to its MedSurg segment:

> *"Substantially all MedSurg sales are recognized when a purchase order has been received and control has transferred.* ***For certain Endoscopy, Instruments and Medical services, we may recognize sales over time as we satisfy performance obligations that may include an obligation to complete."***

MedSurg sales account for about 45% of total sales and all the major components were showing healthy growth for the nine months ended 9/18 (Instruments-8.6%, Endoscopy-12.8%, Medical-6.7%). Therefore, the sudden sequential decline in contract liabilities is a concern as it could be an indication that revenue in the current quarter benefitted from an accelerated recognition of previously deferred revenue. We will continue to monitor this going forward.

Inventory Has Been Building

As a medical products producer, SYK must carry a large inventory of expensive products in various sizes to meet all its customers' needs. However, SYK's inventory has been building as it is phasing in new products. This can be seen in the following table which shows the calculation of inventory days (DSI) of the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$1,087	$1,132	$1,104	$1,235
Inventory	$2,893	$2,740	$2,664	$2,465
COGS YOY growth	6.4%	10.9%	11.4%	15.3%
Inventory YOY growth	17.9%	20.2%	22.7%	21.4%
Inventory DSIs	242.9	220.9	220.2	182.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$1,022	$1,021	$991	$1,071
Inventory	$2,454	$2,279	$2,172	$2,030
COGS YOY growth	6.5%	2.3%	23.7%	19.7%
Inventory YOY growth	17.3%	14.6%	22.9%	23.9%
Inventory DSIs	219.1	203.7	200.0	173.0

While there has been no specific discussion of the inventory in build in the company's recent 10-Q filings, management did offer some color at a recent analyst day presentation:

> Katherine Owen:
> *"Yes, we've had been spin related to ERP and some of that has been broadening as we've expanded its scope of some of the CTG initiative given the acquisitions. We've got increasing organizational focus around it. We did have to build a lot of inventory and a lot of that was tied to our product lifecycle management program or PLCM, which is one of the CTG initiatives. And so, it is a very complicated process when you're doing, phasing out a product, you've got a build-up inventory of the products you're getting rid of. You've got to build up inventory of the products you're keeping. There's different implications and different locations geographically and because you don't want to have -- you want to have a very smooth transition there. And so that's one of the big drivers around the inventory build that's impacted some of the free cash flow."*

We can clearly see the disruption in inventory brought about by the product cycle and management's explanation seems plausible. However, with four straight quarters of 10+ day year-over-year increases in DSIs and levels near a historical high, we will start being concerned if we don't see inventory growth begin to trend more in-line with sales in upcoming quarters.

Baxter (BAX) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	4-

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

We are lowering our rating on Baxter (BAX) from a 4- (Acceptable) to a 3- (Minor Concern)

BAX reported adjusted EPS of $0.80 in the 9/18 quarter. This was 6 cps ahead of consensus which the company attributed to "*solid operational performance and ongoing benefit from our business transformation initiatives and the lower tax rate."*

However, we saw several points of deterioration in the company's earnings quality during the period:

- Inventory days (DSIs) jumped by almost 13 days over the year-ago period. Management blamed this on overproduction at its new North American manufacturing facility, strategic buildup of certain products to ensure availability, but also noted that it was due to missing its sales forecasts. Most of the inventory increase was centered in work-in-process which seems to indicate an unexpected buildup in product was not the major contributor. Nevertheless, the sudden jump increases the risk of an unexpected disappointment in the next couple of quarters.

- Results have been receiving an approximate 3 cps tailwind from a change in the company's US pension plan for the last three quarters. While the company has cited this benefit prominently in its discussion of results, the significant boost will nonetheless be gone after the fourth quarter.

- Results have materially benefitted from discrete items favorably impacting the tax rate versus management's guidance.

Inventory Buildup

BAX saw a noticeable buildup in inventory during the 9/18 quarter, as inventory days (DSI) jumped by almost 13 days over the 9/17 quarter as shown in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$1,531	$1,603	$1,563	$1,616
Inventory	$1,718	$1,622	$1,581	$1,475
COGS YOY growth	-2.9%	8.8%	9.2%	4.7%
Inventory YOY growth	10.8%	6.4%	6.8%	3.1%
Inventory DSIs	102.4	92.3	92.3	83.3

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$1,577	$1,473	$1,431	$1,543
Inventory	$1,550	$1,525	$1,480	$1,430
COGS YOY growth	6.1%	-8.7%	1.5%	0.8%
Inventory YOY growth	-1.1%	-4.1%	-12.0%	-10.8%
Inventory DSIs	89.7	94.5	94.4	84.6

In the opening comments of the third quarter conference call, the company indicated that the buildup in inventory was related to improving product availability:

> *"Before turning to 2018 outlook, I will briefly comment on our cash flow performance. In the first three quarters of 2018, we generated free cash flow of $873 million with improvement in net income offset by higher inventory levels as we worked to rebuild supply for select products to ensure adequate product availability."*

BAX's Puerto Rican IV solution production facilities experienced a shutdown in the third quarter of 2017 from Hurricane Maria. During that time, customers increased their orders to stockpile inventories to prepare for any shortages. In addition, customers changed protocols for medication delivery which changed order and demand patterns for BAX's products. This led to disappointment in segment sales in the 9/18 quarter as management explained in the 9/18 call:

> *"And while not directly related to the hurricane's impact on our production levels, the historic tight supply in the market for IV solutions has also impacted performance for the Medication Delivery business this year. Sales of large-volume IV solutions spiked in the first five months of the year, driven by increased purchases, given the protracted industrywide supply challenges, coupled with an intense flu season. Customers rushed to acquire any available IV solutions products.* ***This resulted in***

growing inventory levels across our customer base. Our forecast was built off this elevated run rate and didn't contemplate the level of inventory destocking we're currently experience as supply constraints have eased."

Management also went on to explain that while some of the inventory build was due to ensuring availability of certain products, there was also a component of the buildup related to lower-than-expected demand:

"One is ***to the extent that you fall short on a sales forecast, it's very difficult to adjust your supply chain planning such that there's not an inventory build that takes place.*** *The second thing is we're very pleased with the performance coming out of our North Cove manufacturing facility but that has been overproducing in terms of getting fully back up to speed ahead of our expectations which is another factor contributing a bit to the inventory build. And then as we said earlier, when we look at year-over-year performance, we did make some strategic decisions to make select product inventory builds. So really, those are the three factors that we see. We do not see this as a structural issue. And frankly, once we kind of tighten up our forecast going into next year, this will be an opportunity for us to claw this back."*

We can get a little more insight into the source of the build by looking at the inventory components as a percentage of total inventory which is shown for the last eight quarters in the table below:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Raw Materials % of inventory	21.7%	22.9%	22.8%	23.5%
Work in Process % of inventory	13.0%	11.0%	10.5%	7.9%
Finished Goods % of inventory	65.3%	66.1%	66.7%	68.6%
	100.0%	100.0%	100.0%	100.0%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Raw Materials % of inventory	22.6%	21.6%	21.7%	22.3%
Work in Process % of inventory	8.7%	9.2%	8.8%	8.5%
Finished Goods % of inventory	68.6%	69.2%	69.5%	69.2%
	100.0%	100.0%	100.0%	100.0%

We see that the bulk of the build has been in work in process which seems to indicate that the largest part of the buildup is related to increasing production rather than the company sitting on a glut of finished product it will have to discount or write off. Nevertheless, given the sudden jump and management's admission that overzealous sales forecasts played a

role in the spike, we believe there is a risk that the next quarter could be negatively impacted by the elevated inventory level.

Easy Pension Comps Ending After Next Quarter

In January of 2018, BAX announced it was freezing the accrual of new benefits after December 31, 2022 for current employees in its US pension plan. This resulted in an immediate reduction in the projected benefit obligation of $57 million. As a result, periodic pension cost fell to a lower level in the 3/18 quarter, as seen in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Pension Expense	$14.0	$15.0	$14.0	$36.0
	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Pension Expense	$36.0	$36.0	$35.0	$35.0

The company has highlighted the beneficial impact of lower pension costs in its commentary on operating results. Nevertheless, the above table puts in perspective that the last three quarters have benefitted from an approximate $22 million (3 cps) tailwind as a result of this non-operating factor which will disappear after the 12/18 quarter.

Lower Tax Rates Boosting Results

The last three quarters have all benefitted from lower than expected tax rates. In the first quarter, the company beat expectations, but admitted this was partially due to lower than expected tax rates during the conference call:

> *"On the bottom line, adjusted earnings increased 21% to $0.70 per diluted share. This exceeded our previous guidance of $0.60 to $0.62 per share, driven largely by operational performance and a* ***lower than expected tax rate, due to certain discrete items we recognized during the quarter."***

The adjusted tax rate was 14.5% for the quarter, which reflected a benefit of $13 million from FAS 123-R stock compensation guidance as well as certain discrete items we recognized in the quarter that favorably impacted the rate.

The company lowered its guidance for a full year-2018 tax rate to 19%. The second quarter once again benefitted from a lower than expected rate with management offering the following color:

"The adjusted tax rate was 17% for the quarter, which includes a benefit of $15 million from stock compensation. And as previously mentioned, adjusted earnings of $0.77 per diluted share exceeded our guidance of $0.69 to $0.71 per share driven by solid top-line performance, our business transformation initiatives, a ***lower than expected tax rate,*** *and other income."*

"On the bottom line, adjusted earnings increased 22% to $0.77 per diluted share. This exceeded our previous guidance of $0.69 to $0.71 per share, driven by solid top-line performance, the ongoing benefit of our business transformation initiatives, ***a lower than expected tax rate****, and other income."*

The company again lowered its forecasted full-year rate to 17% rate during the second quarter conference call. However, management again cited a lower than expected rate in the third quarter during the conference call:

"The adjusted tax rate was 17.1% for the [9/18] quarter, which includes a benefit of $9 million from stock compensation. ***This came in favorable to our expectations, driven primarily by certain discrete items recorded in the quarter."***

The company is still expecting a 17% rate for the full year.

We estimate that the lower rate could have added 2-3 cps to the most recent quarter. While the company would have still topped estimates in the period without this, investors may have become too dependent on a benefit that could very well reverse in upcoming quarters.

Clorox (CLX) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	4-

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

We are maintaining our *EQ Review* rating on Clorox (CLX) at 4- (Acceptable)

CLX reported EPS of $1.62, 3 cps ahead of the consensus number. We saw no significant changes in CLX's earnings quality in the 9/18 quarter and are maintaining our current earnings quality rating. We have the following observations on the quarter:

- While inventory days (DSI) rose by over 2 days over the year-ago quarter, this is similar to the increase seen in the previous quarter and likely due to the 4/2/18 acquisition of Nutranext which management admitted carries a higher percentage of working capital to sales than CLX's core business. In addition, finished goods as a percentage of total inventory fell year-over-year which further alleviates concern.

- We have noted in previous reviews that results benefited from easier comparisons for advertising expense. This benefit is now up as advertising as a percentage of sales was flat at 10%.

Lancaster Colony (LANC) 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 slightly lowering our EQ Review rating on Lancaster Colony (LANC) to a 3- (Minor Concern) to reflect a worsening of the red flags we had previously identified.

- Inventory DSIs jumped by 5 days year-over-year in the 9/18 quarter. This is an acceleration from the 3-day increase in the 6/18 quarter. In addition, raw materials as a percentage of total inventory rose by 220 bps which seems to rule out rising costs as a major driver of the increase. Management's explanation of an increase in sales volume and an increase in planned forward coverage is possible, but such a pronounced jump centered in finished goods always deserves attention.

- Accounts payable days continued to rise rapidly, but given the relatively low level of payables, we believe this trend could run for some time.

Inventory Growth Accelerated

We highlighted in our last review that LANC's inventory days (DSIs) rose over three days in the 6/18 quarter. The growth in inventory relative to sales continued to accelerate in the 9/18 quarter, as seen in the following table.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Inventory	$103	$91	$88	$78
COGS	$235	$232	$228	$236
Inventory DSIs	39.8	35.7	35.2	30.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Inventory	$85	$76	$80	$80
COGS	$223	$217	$222	$233
Inventory DSIs	34.8	32.1	32.7	31.4

DSIs increased by 5 days in the 9/18 quarter which the company attributed to the following factors during the conference call:

> *"The noticeable increase in inventory was anticipated and reflects the impact of several items, including increased sales volumes, continued higher input cost from commodities, balancing of production within our plants for seasonal inventory builds and adjustments to our days of forward coverage to maintain high levels of customer service."*

We admit that the company has seen an uptick in sales growth which was 5.9% and 6.3% in the 9/18 and 6/18 quarter, respectively. This was up from essentially flat in the 3/18 quarter and down 2.2% in the 12/17 quarter. It is also plausible that rising costs could contribute to an increase in inventories. However, we are struck by the significant shift in finished goods inventories witnessed during the quarter which is shown in the table below:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Raw Materials % of inventory	36.5%	36.0%	39.1%	44.7%
Finished Goods % of inventory	63.5%	64.0%	60.9%	55.3%
	100.0%	100.0%	100.0%	100.0%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Raw Materials % of inventory	38.7%	37.2%	38.3%	40.1%
Finished Goods % of inventory	61.3%	62.8%	61.7%	59.9%
	100.0%	100.0%	100.0%	100.0%

While finished goods inventories did increase 120 bps as a percentage of total inventory in the 6/18 quarter over the year-ago period, they jumped by 220 bps in the 9/18 quarter as raw materials fell. If rising costs had been a major contributor to the rise in DSIs, we would have expected to see a more balanced increase between raw materials and finished goods. The rise in finished goods matches with the company's explanation of a seasonal buildup and an increase in forward coverage. Nevertheless, the distinct acceleration in the buildup deserves attention and raises the possibility that some of the buildup was not planned. This issue deserves continued attention in the next quarter.

Payables Continue to Rise

Another trend at LANC we have been observing is its rising payables level which continued into the 9/18 quarter. LANC discloses the amount of contribution in progress which is included in accounts payable. That number has risen in the last few quarters, so we will adjust it out to get a more accurate reading of the trend in trade payables. This is shown in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$235.455	$231.988	$228.261	$235.724
Accounts Payable	$67.483	$57.978	$58.187	$52.579
Construction in Progress in Accounts Payable	$3.219	$2.070	$1.279	$0.446
Adjusted Accounts Payable	64.3	55.9	56.9	52.1
Adjusted Days Payable	24.9	22.0	22.7	20.2

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$223.441	$217.388	$221.929	$233.034
Accounts Payable	$47.796	$41.353	$41.840	$39.420
Construction in Progress in Accounts Payable	$0.590	$0.622	$1.887	$1.298
Adjusted Accounts Payable	47.2	40.7	40.0	38.1
Adjusted Days Payable	19.3	17.1	16.4	14.9

Management offered the following explanation of the rising payable in the conference call:

> *"As we conveyed last quarter, the increase in our accounts payable since June largely reflects an emphasis by our procurement team to extend payment terms with our vendors in conjunction with our ongoing lean six sigma efforts."*

We would also add that the increase in inventories, regardless of source, would also have an elevating force on payables.

As we noted in our previous review, LANC's payables are relatively low and it seems that the company has some room to run in boosting cash flow by optimizing payables. We are therefore not overly concerned with this trend.

Home Depot (HD) EQ Review Update-10/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	5-

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

We are lowering our *EQ Review* rating on Home Depot (HD) to 4- (Acceptable) from 5- (Strong.)

- Inventory days (DSI) jumped by 3.7 days over the 10/17 quarter. Management stated that this was a planned build meant to increase availability and some inventory pre-buying. We are not overly alarmed by this as inventory was still in a normal seasonal range. However, this is an item to monitor going forward and prompts us to lower our rating from 5 (Strong) to 4 (Acceptable.)

Inventory DSI Jumped by More than 3 Days

HD's inventory days (DSI) jumped by 3.7 days over the 10/17 quarter as shown in the following table:

	10/28/2018	7/29/2018	4/29/2018	1/28/2018
COGS	$17,151	$20,098	$16,330	$15,790
Inventory	$14,754	$14,044	$14,432	$12,748
COGS YOY growth	4.7%	7.8%	3.8%	7.8%
Inventory YOY growth	9.9%	9.1%	6.0%	1.6%
Inventory DSIs	78.5	63.8	80.6	73.7

	10/29/2017	7/30/2017	4/30/2017	1/29/2017
COGS	$16,378	$18,647	$15,733	$14,654
Inventory	$13,419	$12,868	$13,609	$12,549
COGS YOY growth	8.4%	6.3%	5.1%	6.0%
Inventory YOY growth	1.3%	4.4%	3.0%	6.3%
Inventory DSIs	74.8	63.0	78.9	78.1

Management made the following comments regarding the inventory rise in the conference call:

Carol Tome:
"The growth in our inventory versus last year reflects the investments we're making to accelerate merchandising expense [ph], higher in stock levels than we had one year ago and some pull forward of planned inventory purchases."

Marc Brown:
"We continue to expect to see inventory productivity here at the Home Depot, but customer service begins with in-stock, so we really focus mostly on our in-stock. We have implemented tiered replenishment strategies that really provide focused investments to drive sales and in-stock where it matters the most. And the results we're seeing from that are really very good. We've actually reduced the number of out of stocks per store by 24% in our top selling SKUs and folks bringing that to life with the new in-store processes, we feel great about our shelf availability there. On top of that, we've improved our direct fulfillment center in-stocks and service levels to the customers and setting new records in terms of in-stock there. So pleased with our in-stock levels and the investments we've made there."

Looking further back than 8 quarters tells us that third-quarter DSIs were approximately 80 in both 2016 and 2015, implying that inventory is not especially out of line with recent historical trends. This fact coupled with management's comments above reduce our concern level. Regardless, any sudden increase in inventories at a retailer deserve attention going forward.

Thermo Fisher Scientific (TMO) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
4+	4+

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

We are maintaining our *EQ Review* rating on Thermo Fisher (TMO) at 4+ (Acceptable).

TMO reported adjusted EPS of $2.62 for the 9/18 quarter, 7 cps ahead of the consensus targets.

- We estimated a lower-than-expected adjusted tax rate could have added as much as 2.6 cps to EPS in the period but did not account for a significant portion of the earnings beat.

- Inventory balances adjusted for ASC 606 still look good.

Lower Adjusted Tax Rate Added 2.6 CPS

TMO's adjusted tax rate for the 9/18 quarter was 11.5%. Management made the following comment during the conference call:

> Stephen Williams:
> *"We delivered $0.12 more adjusted earnings per share in Q3 than we had assumed at the midpoint of our previous guidance. This is driven by $0.10 stronger operational performance and $0.05 better below-the-line driven by FX, lower interest costs and lower tax."*
>
> Later in the call:
> *"Our adjusted tax rate in the quarter was 11.5%, down 30 basis points versus last year, primarily due to the impact of U.S. tax reform. The adjusted tax rate was lower than last quarter due to the timing of discrete tax planning items."*

The adjusted tax rate fell sequentially to 11.5% from 12.3% in the 6/18 quarter. With management's comments above in mind, if we assume the entire sequential decline in the rate was unexpected, that only amounts to an EPS benefit of about 2.6 cents which is far less than the reported earnings beat. We also doubt the entire decline was unexpected given that management stated in the last call that the 12.3% rate was higher due to the timing of tax initiatives. Therefore, we are not concerned that the earnings beat was overstated due to the tax rate.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

Disclosure

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