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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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"America is never wholly herself unless she is engaged in high moral principle. We as a people have such a purpose today. It is to make kinder the face of the nation and gentler the face of the world."

-George H. W. Bush (1924-2018)

GameStop (GME) 3Q Update

GameStop has all the signs of a company clearing the decks for a new CEO in its most recent earnings. Global sales rose, and it is calling for a lower tax rate, yet it is cutting guidance on EPS:

Guidance	Prior	New
Totals Sales	-2% to -6%	-2% to -6%
Comp Sales	Flat to -5%	Flat to -5%
Tax Rate	26% to 27%	23% to 24%
EPS	$3.00 to $3.35	$2.55 to $2.75
Cap Exp.	$110 to $120 mm	$100 to $110 mm

Working backwards, GME is essentially forecasting a margin decrease of about 100bp and it is seeing margin pressures in several areas such as new hardware, new software, and pre-owned products. Guidance for free cash flow was reduced from $300 million to $200 million due to inventory increases and setting a tax dispute.

The company had very few comments on the sale of Spring Mobile for $700 million. It did confirm that it would likely use the funds in a combination of retiring debt, repurchasing shares, and funding operations. It also pointed out that it will not be buying any shares until it completes its review of repositioning the company and hires a new CEO. The $155 million dividend could see improved coverage through a combination of fewer shares, lower interest expense, and reduced operating costs. We believe the company will experience a couple more quarters of write-offs and start some significant cost-cutting. The question is will they reduce the dividend? We think if it is going to happen, it would occur soon as part of the overall strategic review to right-size the company and the key is their view on future margin pressure:

- GameStop took $557 million in goodwill impairments in the quarter, which is far above the guidance provided in its filings

- Not much has radically changed since 2Q, in fact some sales trends improved, so the huge write-off looks like GME is trying to get as much bad news out as possible before the new CEO is hired

- Preowned sales continue to falter, and competition may be increasing, this could hurt the efforts to preserve customers and perhaps lead to inventory write-downs. As the biggest division, pressure in this unit has a large impact on results

- We expect more write-offs for leasehold improvements and PP&E as many stores are likely to close in efforts to reduce operating costs which could also mean more goodwill write-offs

- Another sign of clearing the decks – GME settled its tax issues with France in the quarter and paid approximately $30 million reducing forecasts for free cash flow

- By managing the decay by reducing expenses, GME should continue to produce solid cash flow. A path to growth may be difficult to achieve

GameStop's Write-Off Far Exceeds What Its Testing Guidelines State

The write-off for goodwill was $557.3 million in the 3Q18. There are two issues here. The bulk of the goodwill is in the US as the foreign goodwill has already experienced some sizeable write-downs in 2012. Results grew in the 3Q18:

	3Q18	3Q17
Sales	$2,084	$1,989
Gross Profit	$691	$689
SG&A	$567	$565
Depreciation	$30	$37
Op. Income	$94	$88

2017	U.S.	Canada	Australia	Europe	Tech
Goodwill	$1,160	$30	$74	$87	$317

Here is the discussion on this in the 10-K,

> *"Based on the results of our annual impairment test in fiscal 2017, the fair value of our United States reporting unit exceeded its respective carrying value by 13%. The fair values of our Canada, Australia and Europe reporting units exceeded their carrying values by 8%, 4% and 2%, respectively."*
>
> *"Variations in any of the assumptions used in the discounted cash flow analyses may arrive at different estimated fair values that could result in a material impairment charge. Assuming all other factors unchanged, **a 10% decrease in the projected net cash flows in each of our segments would result in impairment charges of approximately $5.0 million, $5.0 million, $20.0 million and $20.0 million in our United States, Australia, Europe and Technology Brands segments**, respectively. Alternatively, assuming all other factors unchanged, **an increase of 100 basis points***

> ***to the discount rates utilized in the tests of each our segments would result in an additional impairment charge of approximately $3.0 million in Technology Brands, with no impairment charges in the Video Game Brands segments. Sustained declines in our stock price and related market capitalization could impact key assumptions and the estimated fair values of our reporting units that could result in material goodwill impairment charges.*** *We can provide no assurance that we will not have impairment charges in future periods as a result of changes in our operating results, our assumptions or in our stock price."*

There is considerable leeway for management judgment to impact the valuation of goodwill. It seems odd to us that a 10% decline in projected US Video Game cash flows would only result in a $5 million impairment, a 100bp increase in the discount rate would have no impairment, and there was no impairment taken in the first half of 2018 when operating income fell from $145 million to $79 million and the company affirmed guidance. Furthermore, the company announced the sale of its weaker segment after 3Q, this could have been a big part of the reason for the write-down as the technology brands unit had $317 million in goodwill prior to the sale.

However, the company only listed the cause as the decline in the stock price. The stock price has been falling since 2013 from $55 to end 2017 at under $17. There was no market cap driven impairment taken during that time. The stock was $12 in 1Q18 and has been hovering between $13-$15 since. Arguably, having the market cap fall below $1.38 billion vs. about $1.35 billion in goodwill could play a role. In our view, some of this write-down was due to management trying to improve the balance sheet and take a large enough hit to goodwill to prevent further write-downs.

It looks more like what most people call a "Big Bath" charge to get past being close to the edge and not having to recognize a series of smaller "one-time" charges. This may remove much of the goodwill from the technology brands unit ahead of the sale of Spring Mobile.

Preowned Sales May Not Recover

Historically, this has been a material part of the business as the largest percentage of gross profit:

	3Qs 18	3Qs 17	2017	2016	2015
Pre-Owned Sales	$1,345	$1487	$2,150	$2,254	$2,375
Pre-Owned Gross	$589	$679	$977	$1,044	$1,115
Margin	43.8%	45.7%	45.4%	46.3%	46.9%

Gross Margin	3Qs 18	3Qs17	2017	2016	2015
New Hardware	$106	$102	$163	$154	$176
New Software	$326	$351	$590	$600	$689
Pre-Owned	$589	$679	$977	$1,044	$1,115
Accessories	$195	$152	$255	$235	$255
Digital	$117	$108	$162	$155	$150
Collectibles	$144	$131	$208	$172	$117

The company points out that some of the variability of pre-owned results stem from the timing of new release hardware and software. People trade in equipment and games to buy new items. So, when new releases are few or are not well-received – the trade in market goes down. Also, there is a lag for trading-in too because the bulk of the new games and hardware are not sold immediately. So, a new hit game may sell well for 3-4 quarters, but that may break down into a modest 1Q due to lack of supply early on, higher 2Q, and then peak in 3Q. That game won't be traded back in big volumes for perhaps 3-5 more quarters. **The company noted on the earnings call that the trade-in cycle seems to be extending as people hold physical games longer.**

However, the decline has been steady with accelerations in periods such as 2018. We think the changing rates of speed are due more to the timing of trade-ins and the availability of new games. But there are also more competitive options taking market share. GME has warned it faces a risk from people buying more games digitally. Those do not get traded back in and reduces the size of the overall market for future pre-owned sales.

In the 3Q18, the company also warned that there are more options to buy older games online. Current CEO Shane Kim noted,

> *"We are seeing more of an impact of that [digital access to older games] in recent months and it does have to do with how customers can get some of those older titles, the very inexpensive titles that you can get through either subscription memberships or online in a pretty heavily discounted mode."*

The problem is the operating model relies heavily on buying back older games and equipment at a discount for store credit used to buy a new game. GME ends up acquiring inventory for a high margin area and hopes to create a new sale in the future when the current new game is traded back. Digital sales are cutting the volume of trade-in games. Also, customers can find older games online at lower prices.

This area is not going to vanish immediately, but we believe it will face lower sales and weaker margins if it is forced to reduce prices. GME is making margins of 10%-12% on new hardware and 22%-24% on new software. So, with margins on the pre-owned gear at over 40%, they will trade some margin points to boost sales. But there is a worse situation that may be building – what if the volume of used gear is declining and growing unit sales in this area simply isn't a realistic option? Then, they just make less profit on each unit and the decay in this area continues.

It is possible that there are some write-downs here if the value of the used software is being pushed down by competition at this point, it doesn't appear that GME is cutting prices. Rob Lloyd the CFO reported this saying fewer promotions were offered to customers in 3Q,

> *"Our pre-owned business declined 13.4% in the quarter. We continued to see declines in pre-owned software, reflective of fewer title launches and a decline in physical software sales earlier in 2018, which affects inventory levels, weakening demand in the face of digital adoption, including digital access to older titles and fewer promotions offered to our customers in the quarter. We experienced growth in the pre-owned hardware category."*

More Write-Downs Possible in PP&E as Stores are Closed

Comp sales have been weak for GME for some time and they are very seasonal with Christmas being a key time for video game sales. When the company announced a $205 million increase in inventory – about $70 million more than last year as they accelerated purchases of new games launched earlier than last year – we were not concerned as that is seasonal and they should sell it all. But that doesn't change that comps remain slow:

Store comps	3Q18	2Q18	1Q18	4Q17	2017	2016	2015
US Stores	3.4%	2.4%	-2.6%	14.2%	4.3%	-13.5%	4.8%
Intl. Stores	-0.5%	-6.4%	-11.6%	8.3%	9.2%	-4.4%	3.0%

The great 4Q17 figures were helped by adding a 14th week in the period and that helped 2017 results as well.

The company has flexibility. With repeat customers who have store credit and growth in online sales – people are likely to still seek out another GameStop store if their primary location is closed. We discussed reverse cannibalization in early reports on GameStop, where comp sales rise at remaining stores because sales from the closed stores migrate to the remaining ones. This company is really set up for that.

The average lease remaining on Video Game stores is under two-years. That allows them to exit stores more easily with minimal cost. We expect that after Christmas, many stores will start to be closed. Ultimately between reduced rent expense and wages – we would not be surprised if GME can pull at least $200 million in cost out of the business model. Rent expense last year was $442 million, which included the Spring Mobile division. There were 22,000 full time employees and 25,000-45,000 part-time employees which changes based on seasonality of the business.

There will be more write-offs though. Most of PP&E is buildings, leasehold improvements, fixtures and equipment. The net figure here was just under $400 million at the end of 3Q18. Getting rid of Spring Mobile will lower that and then if GME announces 500-800 store closings over the next two years – a large percentage of that will be written off.

GameStop Settled with France on Taxes

We think this is again another piece of getting more bad news behind them. This issue regarding taxes from 2008-15, was being "vigorous contested" and our position is strong and we "have not taken a reserve" in the March 22, 2018 10-K. Then a $30 million reserve was taken, and in the 3Q18, the company paid the $30 million to settle the matter.

One of the reasons the free cash flow forecast was cut from $300 million to $200 million for fiscal 2018 is the higher inventory and this tax payment.

Timing and Conclusion

The Spring Mobile sale of $700 million is expected to close in the current quarter. As we noted last week, we think that cash is likely to pay off the $350 million of 5.5% senior notes due in October. The company cannot buy back shares until it completes its strategic review and likely cannot buy shares until it hires a new CEO and discloses that information.

We are picking on some of the huge write-offs here as being a "big-bath" charge to avoid more charges going forward. However, those are non-cash events other than paying the $30 million in French taxes. Writing off PP&E from closing stores will not consume cash.

Many signs point to some sizeable store closings coming in 2019 and 2020. There may be some cash costs there to deal with employees and closing out leases. However, there is unlikely to be many buyouts of leases given that half the leases expire within two years.

Margins are declining at GME and sales growth has been poor. However, taken as a whole, gross profit is not falling as fast as pre-owned games because digital and collectibles are seeing gains:

	3Qs 18	3Qs 17	2017	2016	2015
Gross Profit	$1,477	$1,523	$2,355	$2,360	$2,502
change	-$46		-$5	-$142	

The company is likely to lose sales to competition if it closes stores and there may be pressure on pricing. That could hurt gross margins further. As noted above, the company is forecasting about 100bp of margin compression in its new guidance. Leaving out the sales and profit of the technology brands (as much of that will be sold) and other – fiscal 2017, sales were $8.1 billion and gross profit $2.35 billion for a 29.0% gross profit margin. On top of this, there remains about $90 million from loyalty programs and there will still be some gross profit from the Apple tech stores.

Paying off the 5.5% notes will save $19.25 million per year. Closing enough stores over two years to save $200 million or more in rent and wages is probably understating how much the company is planning. If they buy 10 million shares for $15, it saves about $19 million pretax in annual dividends. Adding all that up net of taxes, cash needs could fall here about $190 million annually. Also, capital spending was forecast at $110-$120 million before the Spring Mobile sale. Selling that unit and closing many Video Game stores will probably cut capital spending to $50 million – so another $50 million in cash would be saved annually.

The dividend going forward would be $140 million per year and $475 million in bonds due in 2021 would still be outstanding. There would be $200 million in additional cash on hand from the Spring Mobile sale.

The problem is losing 1% of sales costs the company about $23 million in gross profit. Losing 100bp of gross margin costs about $80 million in gross profit. Closing stores and potentially lower selling prices from competitors should lead to lower sales. A 5% drop is $115 million in lost gross profit. It doesn't take a very aggressive prediction of margin reduction and lost sales to see gross profit fall $400 million (10%-12% lower sales and 150bp of lost margin during the transition). That could offset the cost savings.

The current situation points to the dividend having a decent cushion, $300 million if free cash flow vs. $155 million in dividend payments. We will treat the inventory build and French tax payment as one-time events and add that back to the $200 million forecast. Plus, the capital spending figure could fall by $50 million going forward. Cost cutting is coming, cash levels are rising, which is all positive. However, the company is looking at margin pressure and will likely lose sales by closing stores. As it clears the deck for a new CEO by writing off assets, laying out a restructuring, and selling a large division – the dividend could be cut to $0.80 and save $75 million in cash annually with the yield still at 6%. The goal is getting the bad news behind them. If the board is forecasting more margin pressure as they complete the strategic review, they likely are looking at the dividend too. Our belief is the strategic review needs to result in at least $350 million in annual cash savings to offset margin and sales pressure to maintain the dividend long-term. Moreover, the company also needs have a growth plan for the future. Managing decay seldom results in high valuation multiples and the dividend is what holds up the stock price.

Twitter (TWTR) EQ Review- 9/18 Quarter

We are setting the Twitter EQ Review rating at 3+ (Minor Concern) as the situation is improving. We still believe expenses will start to rise at the same rate if not exceed revenue growth and offset some of the earnings gains. We also believe capital spending will reach higher levels. We cannot check advertising expense trends without the annual results but expect those to increase too. However, compared to periods when over half of R&D was not paid with cash, free cash flow adjusted for capital leases, non-cash compensation, and acquisitions was essentially negative or considerably below reported figures – many areas of Twitter's reported results have improved in quality. We would urge readers to review our February 2018 note to see more discussion of these concerns:

- Capital spending is exceeding depreciation again, which reduces some of our concerns that TWTR is using older equipment
- The use of capital leases has fallen and is improving reported cash flow
- R&D is starting to rise, and the amount paid with stock is falling
- Reported cash flow looks better as well and dilution is not as rampant as in the past

Capital Spending

Twitter went two years in 2016 and 2017 when depreciation exceeded capital spending. That is a sizeable issue for a tech company and one that claims to be a growing organization. This has been helping earnings because depreciation has been growing very slowly and we speculated that Twitter was likely using fully depreciated equipment.

	2015	2016	2017
Depreciation	$257	$333	$349
Cap Ex + Cap Leases	$379	$319	$284

We expected this to be a short-lived issue and capital spending would bounce back. Guidance early in the year was for $375-$450 million in capital spending in 2018. So far through 3Q18, capital spending is $410 million plus another $16 million of equipment acquired via capital leases. Guidance for 4Q18 is $60-$85 million in capital spending which would put the company at about $500 million and handily beat the high-end of guidance. With depreciation at $315 million through 3Q18, the trend of picking up cash flow from underinvesting has reversed.

We will note that Twitter has no equipment that is depreciated longer than 5-years. Net PP&E was actually falling! We believe Twitter's capital spending will need to continue rising and may exceed $500 million going forward to deal with growth, normal replacement, plus two years of under-investment.

Twitter Is Using Fewer Capital Leases to Buy Equipment

Capital leases inflate income because the payment is split into interest expense and principal payments. Only the interest expense impacts income, the remaining payment does not reduce income like an operating lease payment.

Capital leases also inflate free cash flow because the principal payment is recorded in the financing section of the cash flow statement. Also, equipment bought with a lease is not listed as capital spending. Free Cash Flow is defined as cash from operations less capital spending. The cash from operations is inflated because income does not have the principal payment. The capital spending is understated because new equipment purchased with a capital lease isn't listed.

Thus, capital leases boost income and free cash flow, but sets up the company for heavy cash repayments in the future.

Twitter was a huge user of capital leases to acquire equipment but that has seen a big improvement in 2018:

	2015	2016	2017	3Q 18
Purchases with Leases	$31	$100	$123	$16
Payments on Leases	$118	$101	$103	$70

In 2013 and 2014 – capital leases were used to buy $156 and $141 million in equipment. Total capital spending was heavily driven with leases:

	2015	2016	2017	3Q 18
Purchases with Leases	$31	$100	$123	$16
Capital Spending	$347	$219	$161	$410
Total Cap Ex.	$378	$319	$284	$426

We think this improves the quality of Twitter's reporting. We'll give them kudos for this change. As leases payments wane, it could allow Twitter to boost capital spending further.

R&D Expenses Are Rising Again and TWTR Is Paying with Cash

This area still needs to rise considerably in our view, but at least it is moving in the right direction now. When a growing tech company cuts R&D to improve cash flow, that's a red flag in our view:

	2015	2016	2017
R&D Expense	$807	$714	$542
R&D paid in stock	$402	$336	$241
Cash Wage %	50%	53%	56%

	1Q17	2Q17	3Q17
R&D Expense	$129	$143	$136
R&D paid in stock	$64	$64	$57
Cash Wage %	50%	56%	58%

	1Q18	2Q18	3Q18
R&D Expense	$123	$139	$151
R&D paid in stock	$47	$45	$53
Cash Wage %	62%	67%	65%

Twitter used to only pay for R&D in cash at about 36% of the total. With the company now being in the mid-60% area – that's a big improvement for earnings quality.

The company used to spend over $800 million on R&D and likely won't hit $600 million in both 2017 and 2018. In our view, there may still be a $100 million headwind on earnings annually going forward to get R&D back to at least $650 million and it will then grow from there. That would be about a 10-cent per share headwind.

One quarter doesn't make a trend, but at least R&D has started to grow y/y again in 3Q18.

Cash Flow Statement Looks Better

By the standard definition of free cash flow, here is what Twitter has reported:

	2014	2015	2016	2017	3Q18
Cash from Ops	$82	$383	$763	$831	$1,008
Capital Spending	$202	$347	$219	$161	$410
Free Cash Flow	-$120	$36	$544	$670	$598

We have discussed many items left out of this view and adjusting for them, Twitter was a cash eating machine. Just looking at the cash figures, the actual cash flow fell considerably:

	2014	2015	2016	2017	3Q18
Cash from Ops	$82	$383	$763	$831	$1,008
Capital Spending	$202	$347	$219	$161	$410
Less Lease Payments	$103	$118	$101	$103	$70
Less Cap Lease buys	$141	$31	$100	$123	$16
Cash Acquisitions	$164	$62	$167	$1	$34
Adj. FCF	-$528	-$175	$176	$443	$478

Slowing the capital spending via capital leases is helping adjusted free cash flow to rise and more closely match the standard definition. We should note that this is penalized to the extent equipment bought in the current year shows up as both a purchase and part of the lease payments.

We have talked about acquisitions too. Twitter considers this to be a key area for its future growth as it may need a new technology or access to a new platform and buying it may be the only way to make it happen. Given that was part of the operating model, we thought the lack of acquisitions in 2017 was a red flag. So, a minor boost to acquisitions in 2018 is a small plus here.

The stock-based compensation and paying for acquisitions via stock remains a concern. People don't want to be paid in a weak stock. The options are worth less if they are less likely to hit strike prices. As noted above, the R&D people are getting paid more in cash than stock than in the past. Heavy use of stock-based payments remains a risk here for cash flow because Twitter may still need to use more cash than stock going forward:

	2014	2015	2016	2017	3Q18
Adj. FCF	-$528	-$175	-$176	$443	$478
Wages in Stock	$632	$682	$615	$434	$244
Acq. with Stock	$148	$517	$1	$0	$19
Total Stock Payments	$780	$1,199	$616	$434	$263

Comparing the Adjusted Free Cash Flow to the total Twitter paid for with stock shows that 2018 is the first time the actual cash flow could withstand going to 100% cash payment model.

Becton, Dickinson (BDX) 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 maintain our EQ Review rating of BDX at 4- (Acceptable)

- Our review of the 9/18 10-K and fourth quarter turned up no significant changes with regards to earnings quality.

- We note that the 12/18 quarter will be the final quarter before the Bard acquisition is lapped which will lead to more informative comparisons starting in the 3/19 quarter.

Impact of Mandatory Convertible Preferred Shares

We remind investors that in connection with the acquisition of Bard, BDX issued 2.475 million shares of mandatory convertible preferred shares in the form of depository rights which entitle the owner to a 1/20 share of the convertible preferred. Par value was $1,000 and the shares pay a dividend of 6.125%. They are convertible into 11.7-14.0 million shares of BDX based on a conversion formula which takes into consideration the price of BDX stock prior to conversion with a mandatory conversion date of May 2020. The company disclosed that 11.675 million shares related to the convertibles were excluded from EPS in the fourth quarter of fiscal 2018 as they were anti-dilutive which was the case in the last several quarters. The convertibles are currently well in the money at the current share price, but the generous dividend rate may delay conversion. Management forecasted a fully diluted share count in fiscal 2019 of 275 million shares, up from 265 million at the end of fiscal 2018.

JM Smucker Company (SJM) EQ Review Update- 10/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3+

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

We are lowering our EQ Review rating on SJM to 3- (Minor Concern) from 3+ (Minor Concern).

SJM reported adjusted EPS of $2.17 which was $0.16 below the consensus estimate. Earnings were penalized by approximately 4 cps from unexpected legal costs and about 12 cps from higher than forecast tax rate due to the gain on the sale of the baking business. However, management did guide full-year fiscal EPS down due to these factors plus lower sales and higher costs.

We cite deterioration in the company's earnings quality in the quarter, namely an increase in accounts receivable.

- Accounts receivables DSOs jumped by 2.5 days over the year-ago quarter. While management blamed this partly on the Ainsworth acquisition, our adjustments indicate that this likely did not account for all the observed increase. Management noted in the conference call for the 7/18 quarter that sales fell later in the quarter than usual. For that to happen again in the 10/18 quarter could be evidence that sales growth has benefitted from increasingly aggressive extension of better payment terms.

- Accounts payable days year-over-year growth flattened in the last two quarters. We suspect this is a result of the Ainsworth deal. We noted in our last review that the company was increasing payables by extending payment times on suppliers. Cash flow growth could benefit in future quarters if the company is able to extend payment times at the new Ainsworth operations as well.

- Pet Food goodwill remains susceptible to more impairments.

Accounts Receivable DSOs up 2.5 Days

SJM's accounts receivable days sales outstanding (DSO) jumped by 2.5 days in the 10/18 quarter as shown in the following table:

	10/31/2018	7/31/2018	4/30/2018	1/31/2018
Sales	$2,022	$1,903	$1,781	$1,903
Accounts Receivable	$562	$504	$386	$423
Sales YOY growth	5.1%	8.8%	-0.1%	1.3%
Accounts Receivable YOY growth	16.7%	16.3%	-12.1%	0.3%
Sales Seq growth	6.3%	6.8%	-6.4%	-1.1%
Accounts Receivable Seq growth	11.4%	30.8%	-8.8%	-12.2%
Accounts Receivable DSOs	25.4	24.2	19.8	20.3

	10/31/2017	7/31/2017	4/30/2017	1/31/2017
Sales	$1,924	$1,749	$1,784	$1,879
Accounts Receivable	$482	$434	$439	$421
Sales YOY growth	0.5%	-3.7%	-1.3%	-4.8%
Accounts Receivable YOY growth	-7.0%	-17.1%	-2.5%	-16.4%
Sales Seq growth	10.0%	-2.0%	-5.1%	-1.8%
Accounts Receivable Seq growth	11.0%	-1.1%	4.1%	-18.6%
Accounts Receivable DSOs	22.8	22.6	22.4	20.5

Management was asked about the increase in receivables during the conference call:

> Analyst:
> "And just had one quick follow-up for you, Mark, in relation to the receivables balance, which was a quite strongly again last quarter. **I think last quarter you talked about some late in the quarter sales coming in through**. Can you give a good idea of what happened this quarter and how that affects the receivables balance and potentially sales, going forward?"
>
> Mark Smucker
> "So there is two things, one is just the absolute increase that came from the Ainsworth acquisition. So that's component of it. The second thing and I'm guessing -- I'm not sure exactly with your point comparison, but if you compare fact to the end of the fiscal year, you have to look at the last month of each quarter. So the last month of the second quarter are -- October is a big sales month if you look at the end of obviously the fourth quarter of last year, it was a smaller so it's just the incremental

> increase in sales dollar. Most of those receivables are still outstanding at the end of the month."

Also consider the company's comments regarding receivables in the conference call for the 7/18 quarter:

> *"Let me address the AR and then I'll let Joe address the Coffee. It actually was – that was part of it, but it was broader than that.* ***If you just look at the way sales fell in the quarter versus a year ago, there was just more sales dollars in the third month, July, if you will of this year versus a year ago****. So, our days sales are trending quite well, just more the mechanics of when the sales actually occurred within the 90 days of the quarter."*

Let's examine the impact of the Ainsworth deal on receivables. The company acquired Ainsworth, a maker of premium pet food on May 14, 2018. This would have had some impact on our calculation of quarterly DSO although this would have been minimized given that the acquisition took place just a couple of weeks into the quarter and almost a full quarter of Ainsworth revenue would have been included in the total company sales figure. SJM does disclose that the value of receivables acquired on 5/14 was $66.3 million and total Ainsworth revenue included in the quarter was $162.8 million. If we take out the $66.3 million in inventory and $196 million in estimated Ainsworth revenue in the quarter ($162.8 million grossed up by 16.7% to account for the two weeks of the quarter prior to the acquisition) we get a very rough estimate of SJM's ex-Ainsworth DSO for the 7/18 quarter of 23.4. This is about 0.8 days lower than the reported total company DSO which includes the Ainsworth impact. This tells us that while Ainsworth's operations carried a higher proportion of receivables to sales than SJM's sore operations, the inclusion of Ainsworth in the mix only boosted total company DSO by less than a day.

We would also note that the company divested its US baking business on 8/31/2018 which would have actually depressed the DSO figure in the 10/18 period as baking receivables would have been removed from the quarter-end balance sheet while the quarterly sales figure would have included 1 month of baking sales. SJM does not disclose either receivables or sales for the baking unit. With that in mind, consider that DSO in the 10/18 quarter jumped by 2.5 days over the 10/17 period. We would assume that the impact of the inclusion of Ainsworth's operations would have actually been smaller in the 10/18 quarter than the 7/18 quarter considering SJM could have had time to improve collections. It is also worth noting that receivables consumed $111.2 million in cash in the 6 months ended 10/18 compared to $41.5 million in the year-ago period. This is more evidence that sales in the

10/18 quarter could have benefitted from the company offering better payment terms in the period which pulled revenue from the current 1/19 quarter forward. This raises the risk of disappointing revenue performance in the 1/19 period.

Payables DSP Growth Levelled Out- May Indicate an Opportunity

We noted in previous reviews that SJM's cash flow was benefitting from extending payment terms, but that its days payable was near the low-end of its peers and that the trend likely had some room to run. As the following table shows, year-over-year growth in accounts payable days (DSPs) was essentially flat the last two quarters:

	10/31/2018	7/31/2018	4/30/2018	1/31/2018
COGS	$1,250	$1,224	$1,091	$1,175
Accounts payable	$552	$532	$512	$471
COGS YOY growth	7.0%	12.7%	-4.1%	1.6%
Accounts payable YOY growth	8.9%	11.4%	7.3%	10.0%
COGS Seq growth	2.1%	12.2%	-7.2%	0.5%
Accounts payable Seq growth	3.8%	3.9%	8.7%	-7.1%
Accounts payable DSPs	40.3	39.7	42.8	36.6

	10/31/2017	7/31/2017	4/30/2017	1/31/2017
COGS	$1,169	$1,087	$1,137	$1,156
Accounts payable	$507	$478	$477	$429
COGS YOY growth	-0.2%	-0.6%	1.6%	-4.5%
Accounts payable YOY growth	16.4%	5.7%	3.9%	15.5%
COGS Seq growth	7.5%	-4.4%	-1.6%	-1.3%
Accounts payable Seq growth	6.2%	0.1%	11.4%	-1.7%
Accounts payable DSPs	39.6	40.1	38.3	33.8

This is likely a result of the Ainsworth acquisition and indicates that the acquired operations carried a lower DSP than SJM's core operations. This could actually play in the company's favor if it is able to use its size to push Ainsworth's suppliers for more favorable payments terms and boost cash flow growth at the combined operations.

Goodwill and Intangibles Still Susceptible to Write-Down

We noted in our previous review that the company has taken several write-downs to the value of goodwill in recent periods and the risk of future write-downs remains. The company specifically addressed this in the 10-Q filing for the quarter:

> *"The goodwill and indefinite-lived trademarks within the U.S. Retail Pet Foods segment remain susceptible to future impairment charges, as the carrying values approximate estimated fair values due to impairment charges recognized in 2018, as well as the recent acquisition of Ainsworth. Any significant adverse change in our near or long-term projections or macroeconomic conditions would result in future impairment charges."*

Resmed (RMD) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3-

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

We are maintaining our EQ Review rating at 3- (Minor Concern).

RMD reported adjusted EPS of $0.81, beating consensus estimates by a penny.

- Warranty expense and the ending warranty reserve balance have been flat while sales have been increasing, leading to a decline in the warranty balance as a percentage of sales falling about 50 bps compared to the 9/17 quarter. While the decline has not been overly aggressive, it is worth noting that it would take about 2 cps in charges to lift the reserve percentage back to the level it was a year ago.

- Accrued expenses declined both sequentially and year-over-year. About half of the decline appears to be related to foreign currency hedging balances. While we don't know the source of the remainder of the decline, this could be an indication that the quarter benefitted from the timing of expense accruals and should be monitored going forward.

- We noted in earlier reviews that RMD sets up third-party financing arrangements for customers to finance the purchase of its products. Outstanding balances remain about 5% of sales so we are still not seeing evidence that revenue growth is dependent on overly-aggressive credit extension. We will continue to monitor this trend going forward.

- The 10-Q cited no material changes with the outstanding tax matters with the Australian Tax Authority.

Product Warranty Balance Has Been Flat as Sales Increase

RMD accrues estimates of eventual warranty costs which are recorded in accrued expenses. The following table shows the progression of the warranty reserve for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Beginning Warranty Balance	$19.227	$19.949	$20.863	$19.956
Quarterly Accrual	$3.948	$4.298	$4.666	$4.573
Quarterly Costs	-$3.589	-$4.271	-$5.642	-$3.816
FX Adjustment	-$0.261	-$0.749	$0.062	$0.150
Ending Warranty Balance	$19.325	$19.227	$19.949	$20.863
% of Sales	3.3%	3.1%	3.4%	3.5%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Beginning Warranty Balance	$19.558	$20.187	$16.914	$17.578
Quarterly Accrual	$3.802	$4.568	$6.386	$3.608
Quarterly Costs	-$3.677	-$5.404	-$3.960	-$3.270
FX Adjustment	$0.273	$0.207	$0.847	-$0.855
Ending Warranty Balance	$19.956	$19.558	$20.187	$16.914
% of Sales	3.8%	3.5%	3.9%	3.2%

We can see that warranty balance has declined slightly year-over-year for the last three quarters and fell 50 bps as a percentage of revenue in the 9/18 quarter. The "quarterly accrual" line in the table is the actual expense charged against the income statement every period. While there was a material year-over-year drop in the 3/18 period, the expense amount has been relatively flat in the last couple of quarters. We also observe that on a trailing 4-quarter basis, the expense accrual has been very close to the actual costs incurred. We would be more concerned if we saw several quarterly drops or even a writeback of the reserve back into earnings. Regardless, the warranty balance is relatively low relative to sales and should warranty experience require the company to boost the reserve back to the 3.9% range would cost the company about 2 cps in charges.

Accrued Expenses Declined

RMD's accrued expense balance in the 9/18 quarter declined both sequentially and year-over-year as seen in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$588.3	$623.6	$591.6	$601.3
Accrued Expenses	$169.5	$185.8	$190.7	$189.4
Accrued Expenses days of sales	26.3	27.2	29.4	28.7

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$523.7	$556.7	$514.2	$530.4
Accrued Expenses	$179.2	$186.3	$169.9	$216.2
Accrued Expenses days of sales	31.2	30.5	30.1	37.2

We also note that accrued expenses on a days of sales basis is the lowest it has been in three years. RMD does not break out the detail of accrued expenses in its 10-Qs, but did offer an itemized disclosure of the account in its 6/18 10-K:

Product Warranties	$19.227
Consulting and Professional Fees	$10.341
Value Added Taxes and Other Taxes Due	$20.130
Employee Related Costs	$109.280
Marketing and Promotional Programs	$3.466
Business Acquisitions Contingent Consideration	$1.505
Hedging Instruments	$2.373
Liabilities on Receivables Sold With Recourse	$2.277
Accrued Interest	$0.120
Logistics and Occupancy Expenses	$6.356
Other	$10.730
	$185.805

We know that product warranties in the 9/18 quarter were roughly flat with a year ago, while heading instruments actually fell by about $5 million from the 9/17 quarter. However, this leaves about $5 million of the year-over-year decline unaccounted for. From the above account detail that it is impossible to tell the exact source of the decline. Nevertheless, such a sharp decline in accruals can be an indication that the quarter benefitted unsustainably from the timing of expense recognition which could reverse in upcoming quarters.

Medtronic (MDT) EQ Review Update-10/18 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 raising our EQ Review rating to 4+ (Acceptable) from 4- (Acceptable).

MDT reported adjusted EPS of $1.22 in the 10/18 quarter. This was 8 cps ahead of the consensus estimate. However, management stated in the conference call that 5 cps of the upside came from better than expected foreign currency experience and another 2 cps came from a lower-than-expected effective tax rate. While still a beat, it was not as strong as the headline number implied. Regardless, we raise our *EQ Review* rating to a 4+ (Acceptable) from a 4- (Acceptable) due to improvement in inventory and payables trends.

- After several quarters of increases, year-over-year growth in inventory days (DSI) flattened out in the 10/18 quarter. Finished goods inventory as a percentage of total inventory rose a reasonable 80 bps over last year.

- Accounts payable days of sales (DSP) declined by 1.6 days. With DSPs at around 72, we are not overly concerned about a quick reversion to historical levels that would pose a meaningful heading to cash flow growth in upcoming quarters.

Growth in Inventory Days Has Levelled Out

We mentioned in our last review of MDT that inventory days (DSI) had shown a marked increase for the last several quarters. However, we also noted that finished goods as a percentage of total inventory was not rising materially which alleviated most of our concern. In the 10/18 quarter, MDT's year-over-year inventory DSI growth has settled down as seen in the following table:

	10/26/2018	7/27/2018	4/27/2018	1/26/2018
COGS	$2,203	$2,204	$2,392	$2,191
Inventory	$3,763	$3,681	$3,579	$3,751
COGS YOY growth	3.8%	-6.3%	-1.8%	-3.4%
Inventory YOY growth	3.4%	4.0%	7.2%	0.8%
Inventory DSIs	155.9	152.4	136.5	156.2

	10/27/2017	7/28/2017	4/28/2017	1/27/2017
COGS	$2,123	$2,352	$2,436	$2,268
Inventory	$3,638	$3,538	$3,338	$3,720
COGS YOY growth	-8.7%	4.0%	3.1%	5.9%
Inventory YOY growth	-2.1%	-1.2%	-3.9%	5.2%
Inventory DSIs	156.4	137.3	125.0	149.7

Inventory composition likewise remains reasonable, as finished goods as a percentage of the total inventory rose by about 80 bps over last year.

Payables Growth Also Moderated

We had also noted that the company's cash flow was benefitting from a rise in accounts payable as it stretched its terms with suppliers. However, days payables (DSP), like DSI, also registered a year-over-year decline:

	10/26/2018	**07/27/2018**	**04/27/2018**	**01/26/2018**
COGS	$2,203	$2,204	$2,392	$2,191
Accounts payable	$1,742	$1,789	$1,628	$1,809
DSPs	72.2	74.1	62.1	75.3

	10/27/2017	**07/28/2017**	**04/28/2017**	**01/27/2017**
COGS	$2,123	$2,352	$2,436	$2,268
Accounts payable	$1,718	$1,759	$1,555	$1,557
DSPs	73.8	68.2	58.2	62.6

The current level of approximately 70 days seems reasonably sustainable and we are not overly concerned of a reversion to recent historical levels causing a significant headwind to cash flow growth.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

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