BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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January 17, 2019 | www.btnresearch.com

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Macy's Inc. (M) - BUY

We started looking at Macy's (M-$24.74) as another hated old-time company with a high dividend yield. The initial news we had seen focused on a valuable real estate portfolio tied to a dying retailer. The company just missed recently-raised Christmas forecasts and we have seen several huge real estate ideas playing out at a much lower reality than forecasts as well – such as Sears, Seritage, and Toys R Us. After talking to the company, reviewing the results and the plans, we came away instead with the view that Macy's may be another Best Buy – a retailer that invested heavily in improving its business model and is now very competitive. There appear to be some levers to boost earnings growth at Macy's too.

The real estate side of the story is largely played out in our view. The company has closed or sold many of the stores it intends to deal with at this point. Large projects such as the flagship stores, Macy's still owns its store space, but sold its various interests in the rest of the project. It still has a deal with Brookfield to redevelop approximately 9 stores. Leaving real estate aside at this point, the stock is selling for 6x EPS, 3.9x EBITDA with declining debt and a 6.0% dividend yield.

We will adjust the reported numbers a bit in the report, but on the surface, the stock may be too cheap to ignore. Essentially, you can buy in after a 20% decline for 6x earnings and get paid 6% in cash while waiting for more improvement. Moreover, the sales comps have already turned positive and much of the heavy lifting of installing new systems and right-sizing the business are now complete. The remaining turnaround plan involves rolling out tested and proven high ROI changes into more stores with an educated staff to do it. We have no significant accounting issues to report and the dividend coverage is actually improving.

- **The Basic Restructuring Story resulted in monetized real estate retiring debt and cutting operating costs to reinvest in the business. At this point, sales have bottomed and so has operating income. Free cash flow is rising** and making the payout ratio for the dividend lower and with debt repayment goals largely achieved – more cash is available for shareholders.

- **SG&A represents a source of future earnings growth even without growing sales.** The completed restructuring charges to close stores, reduce staff and management, change logistics have delivered over $850 million in annualized cost savings. Macy's has spent much of that in the stores on new systems, new stores within the store, training, employee incentives, testing new products and marketing.

- **Macy's is seeing a net $200 million in cost savings now from lower SG&A offset by heavy reinvesting in the stores. Many programs are now fully rolled out.** Others will see another heavy year in 2019 but after that, simply won't require the same amount of investment. We believe Macy's will always focus on reinvesting in the stores, but the full level of investment may decline and allow more of the cost savings to become evident. Even picking up $100 million of the $650 million being spent on reinvestment is 25-cents in EPS.

- **Looking at the top programs rolled out by Macy's with this reinvestment in SG&A – the loyalty program is in place, Vendor Direct is rolled out with logistics, store pick-up operations and online ordering are in place in all stores again with digital logistics. Backstage is already in 170 stores up from 50 a year ago, the Growth50 stores are rolled out with 100 more coming.** It appears that the build-out phases are over in some areas have an end coming.

- **The sales at Macy's have already turned up with five positive comps in a row and several signs point to that continuing.** Early Backstage stores went into lower traffic stores and the first batch are reporting comps of high single-digit growth – now its rollout has more than tripled in 2018 in better stores and all those are going in the comps at various times in 2019. Online sales are a larger part of sales and are growing at double-digits – those are in the comp. Online sales with store pick-up are spurring more traffic and sales in physical stores – those are happening in the comp. Growth50 stores are growing faster – more stores will get that treatment in 2019.

- **Macy's is already doing over 2% in comps – two years of comps at 2% is basically $1 billion in additional sales. At current gross margins, that becomes about $1 in additional EPS** as the company has all the overhead needed in place, it will simply leverage its fixed costs. Here is another source of EPS growth with much of the rollout for it already being in place.

- **Advertising is a potential headwind. Macy's talks about the need to do more marketing with the continued rollout of store changes in 2019.** Advertising as a percentage of sales is up already, but in dollar terms was down slightly last year. We think this is an area where more money could be spent.

- **Gross margin is a wild card too. During the restructuring the company lost 100bp of gross margin. Free shipping for online hurts margin and so does discounting. We think the worst is past Macy's in this area and now** it sees online sales generating additional in-store sales without free shipping. Discounting is being dealt with via Backstage which keeps more new and full-priced merchandise in the rest of the store and Vendor Direct adds inventory assortment without taking it all in the store. We think this will be a +/- 10-50bp move in many years.

- **ROI is already essentially 20% at Macy's even with all the reinvestment of cost savings going on. That's hardly the sign of a dying business.** ROI has room to improve as well as the roll-out of new programs is completed and it results in lower costs along with some sales gains.

- **Macy's has paid down debt and already achieved its debt ratios. They are within the range of 2.5-2.8x leverage without having real estate gains in the EBITDA calculation after a recent debt tender offer.** Going forward, they could be at the low-end with some modest EBITDA growth or minor debt paydown compared to the $1 billion paid in 2018 and 2017.

- **We do not have accounting quality concerns.** The primary pension plan is overfunded with conservative assumptions, it sells its receivables to Citi as part of the loyalty credit card program and receives credit income, and its inventory levels have been very consistent seasonally despite much of the restructuring.

The Basic Restructuring Story – 6% Dividend Looks Safe

While doing better is always a key goal, about five years ago Macy's formulated a plan to right-size and monetize some of its real estate as well as reduce operating expenses as a way to invest heavily in the business to create future growth and improve the balance sheet. These areas have dominated recent financial results:

Income	2018e	2017	2016	2015	2014	2013
Sales	$25,000	$24,837	$25,778	$27,079	$28,105	$27,931
Op. Income	$1,600	$1,554	$1,683	$2,115	$2,795	$2,692
Gains on R/E	$360	$544	$209	$212	$92	$74
Restructuring	-$50	-$186	-$479	-$288	-$87	-$88
Pension Settlements	$0	-$105	-$98	$0	$0	$0
Reported Op Inc.	$1,910	$1,807	$1,315	$2,039	$2,800	$2,678

Macy's is adding the gains on real estate while subtracting restructuring costs and pension settlements to reflect people who leave with a lump-sum distribution as part of operating income. The one-time numbers are material and have been recurring, so we understand why the company is reporting them as part of operating income, but we added the second line of traditional operating income to reflect what the actual retail operations are doing. **The income statement appears to have bottomed out in terms of lost sales and declining operating income from retail operations.** The 2018 results should be essentially 3-years in a row of $25 billion in sales and $1.6 billion in operating income. **That by itself would not lead us to recommend the stock and we will discuss this more below. At this point, our focus is that the bottom may have been reached and the results may be understated with some other short-term items.**

The balance sheet has seen debt fall from a peak of $7.2 billion in 2014 to approximately $4.8 billion now. The share count is down from 378 million in 2013 to 308 million now. The cash flow statement also looks solid enough to sustain the dividend:

Cash Flow	2018e	2017	2016	2015	2014	2013
Cash from Ops	$2,000	$1,944	$1,801	$1,984	$2,709	$2,549
CapX	$800	$760	$912	$1,113	$1,068	$863
Free Cash Flow	$1,200	$1,184	$889	$871	$1,641	$1,686
R/E Sales	$380	$411	$673	$204	$172	$132
Cash for Dividend	$1,580	$1,595	$1,562	$1,075	$1,813	$1,818
Dividend	$465	$461	$459	$456	$421	$359
Debt Paid	$1,100	$954	$751	-$347	-$174	-$276
Repurchases	$0	$1	$316	$2,001	$1,901	$1,571
Net Cash Flow	$15	$179	$36	-$1,035	-$335	$164

Capital spending is coming down from its peak levels as some investments in new software and new retail spending starts to slow. That is allowing free cash flow of simply cash from operations less capital spending to rise and the dividend coverage is improving. The payout ratio was 52% in 2015 and is 39% now. That is without the real estate proceeds, which have largely been devoted to debt reduction.

Again, the point of this is to illustrate our view that even before laying out growth potential, Macy's looks capable of paying a 6% cash return as investors wait for more positive news to drive the stock price. The lower debt levels also make the cash available for the dividend a safer play as well. **The company's goal is to be at 2.5-2.8x Leverage to Adjusted EBITDA.** We will explain this ratio more below, but it includes the gains on real estate in the EBITDA calculation. At the end of 3Q18, the TTM ratio was 2.6x. Since then, Macy's paid down $750 million additional debt, which we include in the $1.1 billion estimate of debt paid in 2018. The $750 million payment reduces the ratio to 2.3x. We spoke with the company and they'd like to be 2.5-2.8x without real estate gains. **After the $750 million and stripping out real estate gains, we estimate, Macy's is already at 2.7x.** Thus, debt reduction may become less of a focus.

Potential Source of Earnings and Cash Flow Growth – SG&A Declining

Looking at the major restructuring charges from 2015-2017, the company's goal was to reduce the number of stores and thus rent expense and wages. It further reduced the number of people in management and back office as well as the number of people per store. The first round of restructuring in 2015 and 2016 was expected to produce $500 million in annual savings by 2018. In reality, it produced about $550 million in cost savings. The final round in 2017, was expected to produce an additional $300 million in cost savings. In a discussion we had with Macy's they have reached that target.

Much of this savings was reinvested in the business. Stores were redesigned, new technology was rolled out such a mobile and tablet apps and virtual reality to help people visualize homewares and furniture in their homes, employees were trained to cross-sell more and work on new retail concepts like Backstage and Bluemercury, and given sales incentives. The company beefed up logistics to serve more online sales and deliver to the various stores. New promotional programs were designed and rolled out. Macy's also did more testing on new products, technology and staff to determine what would be roll-out. Here is the discussion in recent years about this investment boosting SG&A:

> *2017 -- The dollar decrease [in SG&A] from 2016 was mainly due to store closings and the restructuring activities announced by the Company in 2016 and 2017, offset slightly by higher expenses associated with the continued investments in the Company's omnichannel operations, and investments in bluemercury and Macy's Backstage.*
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> *2016 -- SG&A expenses for 2016 increased $6 million from 2015, however the SG&A rate as a percent to net sales of 32.8% was 150 basis points higher in 2016, as compared to 2015. SG&A expenses in 2016 were impacted by lower income from credit operations and higher expenses associated with the continued investments in the Company's omnichannel operations, investments in bluemercury, Macy's Backstage and Macy's China Limited.*
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> *2015 -- SG&A expenses in 2015 benefited from higher income from credit operations and higher gains on the sale of certain store locations and surplus properties, partially offset by higher retirement expenses (including Pension Plan, SERP and defined contribution plan expenses), higher expenses associated with the continued investments in the Company's omnichannel operations, investments in Bluemercury, Macy's Backstage and Macy's China Limited and higher depreciation and amortization expense.*

We can estimate how much of the $850 million in savings is being reinvested by tracking SG&A costs. We will strip out advertising costs and credit income from the SG&A. The credit income used to be lumped into SG&A expense before being broken out as a revenue source with an accounting change last year. There were years when gains on real estate sales were also netted against SG&A and we adjusted for that. Also, SG&A guidance following holiday sales in 2018 is up slightly (prior forecast was flat) vs. the prior year:

SG&A	2017	2016	2015	2014
Reported SG&A	$8,131	$8,474	$8,468	$8,447
Add Credit Income	-$768	-$736	-$831	-$776
Sub Advertising	$1,108	$1,153	$1,173	$1,177
Sub Retirement	$0	$44	$77	$65
Adj. SG&A	$7,791	$8,013	$8,049	$7,981

In the years, 2015-17 the new reinvestment was being done in earnest as the restructurings savings came in. SG&A costs have been basically $8.0 billion for years. In 2017 and 2018, SG&A should have the bulk of cost-cutting in force of $850 million. Yet, SG&A is only down about $200 million. **That indicates to us that there is over $600 million being invested in the new tech, training, logistics, incentive pay, and product roll-out annually.**

Macy's is committed to this business model of refreshing stores and customer experiences, so **some level of reinvestment is likely to always remain. However, eventually the bulk of training is completed. Concepts like Backstage which is a discount store within Macy's to sell marked-down inventory will reach saturation.** In early 2018, Backstage was in 52 stores, now it's 170. It's not going to go in all of the 690 Macy's and Bloomingdales stores. The Growth50 stores are 50 larger stores in top malls that received faster rollout of many of the new concepts like Backstage, adding food/beverages, and furniture – these stores had that attention last year too. More of these store makeovers are coming in 2019, but not all the stores in the portfolio qualify for this treatment. Making improvements to shopping with apps will continue, but the full roll-out will not need to be done again. **Looking at capital spending points to this too. Macy's was spending basically $800 million per year prior to 2014. It then rose to $1.1 billion per year for three years and has returned to about $800 million with a higher percentage being software now than in the past.**

Cap-Ex	2017	2016	2015	2014	2013	2012	2011
PP&E adds	$487	$596	$777	$770	$607	$698	$555
Software Investments	$273	$316	$336	$298	$256	$244	$209
Total	$760	$912	$1,113	$1,068	$863	$942	$764

Management can't give us a timeline on when lower spending may materialize but did agree that the level of investment should decline in the future even though some level will always remain. So far, 2017 and 2018 guidance indicates about $200 million of the $850 million in annual cost savings is being realized now. It is probably not a stretch to say after the heaviest lifting of rolling out full systems is complete – investors may realize $400-$500 million of that cost savings in the form of higher earnings and cash flow. Another key point, this type of investment isn't being capitalized – it's being expensed immediately. Therefore, this investment should help sales for several future years and having the level of investment decline should not hurt sales.

Macy's expects a tax rate of just over 23% so every $100 million of lower SG&A that is realized adds 25-cents to EPS vs. current guidance of $4.00 and a dividend of $1.51 per share. It also adds $77 million to cash flow. This doesn't even really require growth at Macy's – it's really more of running out of places to spend it and it reduces SG&A.

The cash flow statement shown above reflected earnings which added back the restructuring charges. However, the cash portion of those charges – largely severance – was paid largely in the following year. In the case of 2018, some charges taken in 2018 were paid in cash and the 2017 charges were paid in cash in the 2Q18. We treated asset impairments as non-cash and all severance and miscellaneous as cash payment.

CFO	2018e	2017	2016	2015
Dividend	$465	$461	$459	$456
Free Cash Flow	$1,200	$1,184	$889	$871
Div % FCF	39%	39%	52%	52%
Cash Restructuring	$172	$214	$140	$0
Adj. Free Cash	$1,372	$1,398	$1,029	$871
Div % Adj FCF	34%	33%	45%	52%

If the restructuring charges are viewed as non-recurring, then cash flow should rise simply due to their absence. That improves the dividend coverage again without growing the business. If Macy's starts to pick up $100-$300 in SG&A savings simply due to investment plans being completed, that will also bump up cash flow and further improve dividend coverage.

Status of Some Major Investments Impacting SG&A and Sales

We wanted to break some of this out on its own to make it easier to refer back to in all sections of the report.

In the 3Q18 call, the company noted that it completed the groundwork for its five strategic initiatives. Set-up costs are completed and the roll-outs have already been heavy at this point. Here are where some of these stand between one-time and on-going investments:

1. The new Loyalty program roll-out is now past one-year. They added 2 million new users this year. This drives sales and includes some ongoing costs such as discounts on select purchases and invitations to events like cooking classes and fashion shows.

2. Backstage – the store within the store spot for closed out merchandise and sales. They are at 170 of these now and added over 120 in 2018. Each one requires upfront investment to roll out but are still unlikely to roll out at every department store. They plan to boost marketing with there now being some scale to show new products arriving daily.

3. Vendor Direct – This addition to online platforms allows customers to see double the amount of inventory vs. what is in the stores. The build-out here is complete and the on-going costs would be online advertising and free/discounted shipping in Cost of Goods.

4. Store Pick-up. There are four systems here that are available now in all stores. The build-out is essentially complete:

    a. BOPS – Buy Online Pickup in the Store – this allows 2-hour turnaround in shopping inventory in a particular store.
    b. BOSS – Buy Online Ship to Store – This allows shopping of inventory in all of Macy's footprint along with Vendor Direct.
    c. At Your Service – Established a pick-up area that is convenient in every store and handles returns, self-check-out, and fulfillment.
    d. Mobile checkout – Pay with an app on phone or tablet at any time.

5. Growth50 stores – these are larger stores that have wider selection normally in a larger mall with more stores and entertainment options. These get upgrades on PP&E and refreshed appearance – lighting, new restrooms, add food/beverage, they get a Backstage, maybe add furniture options. More marketing to highlight events and new merchandise. 50 have been rolled out and Macy's plans another 100 to roll out in 2019. Again – not every store is going to receive this level of investment which they put at $2.5-$3.0 million per store.

6. We are adding a sixth program which is incentive pay for employees. This is basically commission potential on sales. It encourages cross-selling make-up with clothes, towels with other housewares – Macy's notes this results in higher wages, slows turnover of staff and 75% of store employees earned some commissions last year.

When we look at these programs from a cost standpoint – we see marketing costs, largely online marketing and emails continuing to the top 5 programs. We see the build-out complete for all but Backstage and Growth50. Backstage may still double in size. Growth50 will have a busy year, with 100 additions – but not every store has the size and is in a mall that fits the criteria to become a Growth50 store. So, we think 2019 will see another heavy year of investing and then those two initiatives may see investment levels decline.

In terms of sales impacts for each of these programs, Macy's does not fully break out numbers on them but has been reporting solid results. Here is some of what we do know:

1. Loyalty programs – they are seeing their best customers spending more and shopping more. They continue to add new members (2 million last year). This also translates into customers using the Macy's card tied in with Citi – who pays Macy's credit income. Much of the customer base has already been added to the program so we don't expect too much more in credit income, but Macy's does report the new loyalty program is boosting sales.

2. Backstage – with the disruption, testing and tweaking of this concept – many of the initial stores were rolled out in smaller and less trafficked stores. The results where they have been open more than a year show high single-digit comps for sales growth. The roll-out has now accelerated and the concept will get more marketing and enter stronger traffic stores.

3. The various digital options all have shown growth. Online sales continue to grow at double-digit rates. The mobile and app sales are now over $1 billion from zero a few years ago, so that's about 4% of sales. Vendor Direct added considerable inventory selection to help drive sales too. Finally, the various digital orders being picked up in the stores is boosting store traffic and sales too. Macy's data shows the store pick-up options boost the sale by about 20% on average as many people buy something else at the store.

Sales Trends Show Potential to Leverage Fixed Costs

When Macy's started to rationalize its store footprint, the forecast was it would lose about $1 billion in sales. That assumed that some of the lost business would be recaptured by online or at other stores. This was the one area where they missed as sales fell from $27 billion to $25 billion. That incremental $1 billion was a big deal. At basically a 40% gross margin, the lost gross profit went from $400 million to $800 million – which effectively offset all the cost-savings noted earlier. The comp sales saw some awful results and not many signs of recapturing lost sales. Here are the comps including the licensed commission operations run by third-parties in the stores:

Comps	4Q	3Q	2Q	1Q
2018	x	4.1%	2.3%	1.3%
2017	1.4%	-3.6%	-2.5%	-4.6%
2016	-2.1%	-2.7%	-2.0%	-5.6%
2015	-4.3%	-3.6%	-1.5%	-0.1%
2014	2.5%	-0.7%	4.0%	-0.8%

*Adjusted 2018 sales for the 53rd week in 2017

What is intriguing to us is there is some evidence that the new programs are starting to work and there are easy comps after years of decline. Investors follow this figure most closely and it caused another sell-off in the stock after Macy's boosted 4Q18 guidance and then lowered it after the holidays. They went from flat to 1.0% comp forecasts to start 2018, were clearly beating that and raised to 2.3%-2.5% for the year going into 4Q and then declared 2.0% in January. The stock fell over 20% on the news.

It is important to remember that comps include online sales – which are growing at double-digit rates and have been for years. The company does not disclose the dollar figure for online. But using the rule of 72 – online sales would be doubling every 3.6 years if the growth is 20%, every 4.8 years if growth is 15%, and 7.2 years at 10%. The company does say that online is much larger than the mobile app sales – which are over $1 billion or 4% of total sales. Macy's is seeing incremental sales at the store as online sales increase and customers pick up the order at the store with that new program now fully rolled out.

Also, Backstage was rolled out in a small number of stores in prior years and is now posting high single digit comps. The number of Backstage stores that are going to start entering the comp in 2019 is rising rapidly. Of the 170 opened, about 125 began in 2018 will start joining throughout 2019. They will also represent a rising share of total sales.

Growth50 stores offer the same potential in our view. At $2.5-$3.0 million per store, if the results were not positive on sales and customer traffic, Macy's wouldn't be rolling out another 100 of those in 2019.

Macy's is also ramping up the percentage of its inventory that is private label or third-party but exclusive to Macy's from 20% to 40%. Assuming their work in that area is productive, that should also help sales because it will not simply be an 8th option in buying the same pair of shoes or jeans.

We're simply seeing too many sources of revenue that are growing faster than the already improving comps – about to be added to the comps and other sources that are reaching material levels with faster growth continue to build the comps. The store base is not contracting at this point either – so one year of 4% comps or two years of 2% - the company should recover that lost $1 billion in revenue that occurred during the restructuring.

Recovering the $1 billion at a 40% margin picks up $400 million in pretax earnings or $1 in EPS because the overhead costs are unlikely to change – they aren't adding rent, staff, building a new system, etc. Given the trends, we don't think that is a stretch.

We See Two Potential Headwinds – Gross Margin and Advertising

The company talks about expanding marketing as it rolls out its new programs and stores in a wider manner. Much of this will be digital but also will involve changing out merchandise and moving some to the Backstage which is at a lower price point. In general, if private label becomes a larger part of sales – that could mean lower vendor support for advertising. To the extent Macy's gets more exclusive third-party product, that may boost some vendor support. The company has been boosting advertising as a percentage of sales and holding its own spending fairly stable:

Advertising	2017	2016	2015	2014	2013
Total Spend	$1,397	$1,547	$1,587	$1,602	$1,623
Vendor Allowance	$289	$394	$414	$425	$457
Net Advertising	$1,108	$1,153	$1,173	$1,177	$1,166
% of sales	4.5%	4.5%	4.3%	4.2%	4.2%

We do not believe that as sales increase, Macy's will let the percentage of sales figure decline. It fell off in slightly in 2017 as many new things were being tested and introduced. However, we believe that going forward the advertising budget could rise in total terms back to $1.5-$1.6 billion. If vendor support remains closer to $300 million. Macy's could see advertising rising to $1.2-$1.3 billion vs. $1.1+ billion in prior years. This may be a $100 million headwind.

Gross margin gets hurt from two areas – discounting and free shipping for online purchases. It gets helped from more full-priced sales and licensing sales. Essentially, Macy's has third parties that operate a store within the store and Macy's earns a percentage of sales but has no costs – it's just a landlord. These areas have a minimal sales impact but it's 100% gross margin. Macy's has been expanding this area too.

Gross margin has lost about 100bp during the restructuring activities.

	2017	2016	2015	2014	2013
Gross margin	39.0%	39.4%	39.1%	40.0%	40.1%

Guidance for 2018 went from up slightly to down slightly. We do think the growth in the Growth50, the licensing deals, and the incremental sales at stores when people pick up online orders are designed to boost gross margin. However, discounted or free shipping is a staple of online sales and that area is growing. Backstage is a more complex issue. It represents discounted merchandise which hurts margins. However, it also turns those goods faster and results in more full-priced merchandise in the store and drives more traffic to the store. The presence of Vendor Direct also effectively adds to inventory selection without marking more of it down.

In our opinion, Macy's has probably seen the worst of the disruptions from the restructuring at this point. Management is indicating the traffic is rising and the growth roll-outs are now rolling out in the higher-end stores. We do not see discounting ever going away nor free shipping. 50bp of gross margin is $125 million earnings hit/bonus. We would expect this to be a wildcard that rises or falls in any given year.

Return on Capital More than Adequate and Has Room to Improve

Macy's does some fairly detailed calculations for ROIC in its SEC filings. It uses operating income and adds back depreciation, impairments, and rent expense. It then uses cash invested in the business defined as PP&E + accumulated depreciation, capitalizes leases into debt, and adds in net working capital for an invested capital number:

M's ROIC	2017	2016	2015	2014	2013
Adj. Op Income	$3,438	$3,289	$3,709	$4,221	$4,073
Total Invested Cap	$16,519	$17,771	$18,482	$18,814	$18,979
Macy's ROIC	20.8%	18.5%	20.1%	22.4%	21.5%

We would adjust for the gains on real estate too as those are short-lived and part of the restructuring. That would reduce Macy's figures to this:

M's ROIC	2017	2016	2015	2014	2013
Adj. Op Income	$2,894	$3,080	$3,497	$4,119	$3,999
Total Invested Cap	$16,519	$17,771	$18,482	$18,814	$18,979
Macy's ROIC	17.5%	17.3%	18.9%	21.9%	21.1%

Under either scenario, the company saw ROIC bounce in 2017 and it may be flat or had a small tick up in 2018. Essentially, operating income is roughly flat, and we expect PP&E, receivables, and capitalized leases to be down in the total invested capital figure.

We think under both scenarios, it does not take too much in higher sales or more of the cost savings already achieved to materialize to move these figures higher. $100 million in savings from SG&A adds 0.6% to ROIC and 2% comp sales growth should add 1.2% to ROIC. Moreover, many of the investments that have been rolled out but not fully realized yet would have tested at a high ROI number too. We think it's tough to call out a business as dying when it has ROI of nearly 20% and several levers in place to boost it further.

If we tweak the ROIC calculation to be more of a traditional method – operating income divided by debt + equity, we still get similar numbers. We will leave in the process of adding back rent expense to operating income and capitalizing leases as debt. We also will not add back real estate gains:

M's ROIC	2017	2016	2015	2014	2013
Adj. Op Income	$2,894	$3,080	$3,497	$4,119	$3,999
Total Invested Cap	$14,336	$13,905	$14,457	$15,071	$15,696
BTN's ROIC	20.2%	22.2%	24.2%	27.3%	25.5%

Under this scenario, debt is falling faster in 2018 and would push the ratio up too. Under this scenario, realizing an additional $100 million from the SG&A costs declining as some of the reinvestment is complete adds 0.7% to ROIC and 2% comp sales growth adds about 1.4%.

Paying Down Debt and Leverage Ratios

Macy's is committed to its investment grade debt rating. Part of that goal is to get the ratio of leverage to adjusted EBITDA into the 2.5-2.8x. These calculations are also provided in the company's financial releases.

In this calculation EBITDA starts with net income, adds back the standard interest expense, taxes, and depreciation. It also adds back one-time charges, pension expense, and rent expense. Debt then includes all financed debt, capitalized leases, and unfunded pension liabilities.

We noted early in this report that the company has been aggressively paying down debt the last three years with proceeds of real estate sales. The company had reached its leverage ratio target in 3Q18:

Leverage	3Q18	4Q17	3Q17
Adj. EBITDA	$3,434	$3,379	$3,064
Adj. Debt	$8,789	$9,122	$9,681
Leverage ratio	2.6	2.7	3.2

The company still leaves in the Real Estate gains in the Adj. EBITDA, so the goal is to also meet the leverage ratio target without the gains as those will lap soon. For the trailing 12 months for 3Q18, the gains were $479 million. That would boost the ratio from 2.6x to just under 3.0x.

However, after 3Q18, the company tendered for $750 million in debt. Adjusting debt down for that, the ratio again falls to 2.7x within the target range. We would not be surprised if Macy's retires a bit more debt with free cash flow in 2019 and 2020, but it does not need to be as large of a focus as 2018 and 2017 when the company paid down $1 billion in each year or the $750 million retired in 2016. They would reach the low-end of their target without real estate gains in the EBITDA if debt falls another $650 million or EBITDA rises $260 million or some combo in between. The low-end 2.5x ratio could be done with $300 million lower debt and EBITDA rising $140 million.

In terms of interest coverage, Macy's wants to be in a range of 6.4-6.6x EBITDA to interest on debt on rent. At the end of 3Q18, the ratio was 8.7x and adjusting out the Real Estate gains, the company is at 7.5x. Interest expense will fall further after the additional debt was retired and further boost that ratio.

We Do Not Expect Much More of a Real Estate Story

Macy's has pulled approximately $2 billion in cash from real estate between 2013-18 assuming the latest guidance on final sales hits in 4Q18. The company has also sold the various interest in any JVs of projects with the flagship stores. Thus, while Macy's may have retained 3 floors of a retail store and had upgrades made – it will not collect future rental income from other floors that become office space or other retail.

The company has further largely completed the right-sizing of its physical footprint. It closed over 100 stores and opened a few new ones in the last few years. With 690 department stores remaining and several on lease – it is likely that in any given year a few stores will be closed and a few new ones or standalone Bluemercury or Backspace stores are opened. However, we are not expecting a repeat of recent years when many properties were sold. We expect cash from real estate sales and gains on the income statement to largely disappear in 2019 and beyond and that is why we have been adjusting those out of ratios throughout this report.

There is still one deal outstanding with Brookfield to redevelop 9 properties. Those would still allow Macy's a chance to either sell the properties or participate in a joint venture of refurbishing the property. But, those properties are not Flagship stores that many have touted in the past. We believe much of the hidden value for the real estate has already been harvested.

Overall, Macy's still owns a great number of its stores and has low rent on the remainder. That is an overall cost advantage for the company when competing against other retailers both online and in physical stores.

Looking at the Accounting Overall – We Have Very Little Concerns

The company has two pension plans, both have been discontinued for new employees for many years. The larger one is fully funded and has been getting smaller simply because the many employees who were part of the restructuring were given lump-sum payments and removed the future liability. The liabilities there are $3.2 billion and the assets in the plan are $3.4 billion. Moreover, the assumptions are conservative with a discount rate that is already rising and is now 3.75%-4.0%, they assume 4.1% compensation growth, and the rate of return assumption is 7.0%.

The supplementary pension plan is only $700 million and is unfunded. The annual cost is about $30 million, and Macy's actually lowered the discount rate from 4.07% to 3.78% last year.

The company sells its Accounts Receivable related to retail customers to Citi as part of its credit card program. They receive income here based on amounts earned by the bank and how many customers sign up via the loyal program. This is a bit more seasoned and doesn't have wild swings in income that a program just starting out would have.

For all the revamping going on in stores, inventory levels have been very consistent. We also again point to the Vendor Direct program that allows Macy's to offer much more inventory to customers without having to stock all of it.

	3Q18	2Q18	1Q18	4Q17
Inventory DSIs	202.2	136.2	142.8	89.3

	3Q17	2Q17	1Q17	4Q16
Inventory DSIs	204.5	133.5	155.4	93.8

	3Q16	2Q16	1Q16	4Q15
Inventory DSIs	204.5	140.0	148.9	90.5

The first quarter of 2017 was the only time it moved noticeably and quickly returned to normal seasonal levels.

We even give Macy's high marks for most of its disclosure. It lays out great figures in computing the adjusted EBITDA, adjusted operating income it uses. It also calls out the Real Estate gains and restructuring charges. They may leave the gains in some of the calculations, but they don't hide it and mention it in discussions.

The only thing we can argue with on disclosure and presentations is some of the sales items. If online sales are a big part of the business, it would be good to see a percentage of total sales figure. The same with Backstore, it's a growing part of the business – what are its margins and ROI?

Fortune Brands (FBHS) EQ Review

Current EQ Rating*	Previous EQ Rating
3-	NA

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

We initiate coverage of FBHS with a rating of 3- (Minor Concerns)

FBHS reported adjusted EPS of $0.93 in the 9/18 quarter, a full 12 cps short of the expected $1.05. Management blamed 7 cps of the shortfall on Hurricane Florence with the balance presumably related to a weaker than expected housing market and "temporary inefficiencies" in its security segment. While we are always skeptical of weather-related excuses, we note that the hurricane did not just impact demand, but also directly affected both shipping and production activity in its North Carolina facilities. Management noted in the call:

> *"Hurricane Florence hit our Plumbing operations hard at the end of the quarter and led to eight-lost shipping days as our main Moen assembly plant for the U.S. is in New Bern, North Carolina, and our component warehouse is in Kinston, North Carolina. The effect is to push some sales from Q3 to Q4.*
> *Across the company, we have a number of operations in North Carolina. Although our manufacturing facilities missed some third quarter production time, they are all up and running, having suffered only minimal damage during the storm. "*

Management noted that it expects to recoup all but $0.01 per share in lost sales and profits from the hurricane in the fourth quarter. Regardless, it still lowered guidance for the full year to $3.41-$3.49 from the previous $3.62-$3.72. Management's comments in the call indicated that of the 22 cps reduction in the guidance midpoint, about 13.5 cps was from lowered market forecast, 3.5 cps from increase in forecast for inefficiencies, 3 cps from dilution from the 9/18 acquisition of Fiberon and 1 cps each from unrecovered business from the hurricane and tariffs.

Despite the big earnings miss, we note that the company's recently reported results have benefitted from several temporary sources which cannot continue indefinitely.

- Provision for warranty expense in the 9/18 quarter fell by almost $5 million (2.5 cps) versus last year's unusually high third quarter. The overall reserve level is consistent with recent history, so we are not especially concerned the company is under-reserved at this point.

- Other income increased by over $7 million versus the year-ago quarter due to hedge gains from debt issuance and beneficial moves in the ineffective portion of FX hedges. We consider the approximate 4 cps increase to be a non-operational benefit.

- The company aggressively bought back shares in the 3/18 and 6/18 quarters, reducing the share base by more than 5% and giving a huge boost to reported EPS growth. However, acquisitions have driven up debt to over 2.6 times EBITDA, prompting the company to suspend the buyback after the 6/18 quarter. While the dividend consumes only about 30% of free cash flow, the high debt, coupled with management's indication that more acquisitions are on the way will likely siphon cash away from both future dividend growth and share buybacks.

- The almost 2-day increase in accounts receivable DSOs in the 9/18 quarter was entirely due to the 9/18 Fiberon acquisition. However, the approximate 2.5-day increases in the 3/18 and 6/18 quarters are out of line with the smooth historical trend which prompts us to pay careful attention to the future movement in receivables.

- FBHS took a $27 million write-down to intangible tradenames in the 9/18 quarter and disclosed that two tradenames with total carrying value of $190 million could face write-downs if there is further erosion in estimated carrying value.

Provision for Warranty Decline Added about 2.5 CPS to EPS Growth

FBHS reserves for future warranty costs at the time of sale based on estimates from past experience. The following table shows the development of the warranty reserve for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Beginning Reserve Balance	$17.0	$17.2	$17.2	$22.0
Provision for Warranties Issued	$5.5	$6.4	$6.2	$1.8
Settlements	-$4.5	-$6.6	-$6.2	-$7.3
FX Translation	-$1.9	$0.0	$0.0	$1.2
Acquisitions	$9.1	$0.0	$0.0	-$0.5
Ending Balance	$25.2	$17.0	$17.2	$17.2

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Beginning Reserve Balance	$16.0	$15.9	$16.2	$17.4
Provision for Warranties Issued	$10.2	$4.9	$8.2	$2.0
Settlements	-$3.7	-$4.8	-$8.5	-$2.7
FX Translation	-$1.2	$0.0	$0.0	$0.3
Acquisitions	$0.7	$0.0	$0.0	-$0.8
Ending Balance	$22.0	$16.0	$15.9	$16.2

The company experienced unusually higher warranty expense in the 9/17 quarter which led to a very easy comp in the 9/18 quarter. We estimate that the $4.7 million decline in warranty expense boosted EPS growth by more than 2.5 cps when compared to the year-ago quarter.

The following table shows the adjusted warranty reserve balance as a percentage of sales for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Revenue	$1,380.8	$1,429.0	$1,254.6	$1,382.5
Warranty Reserve	$16.1*	$17.0	$17.2	$17.2
Warranty Reserve % of Sales	1.2%	1.2%	1.4%	1.2%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Revenue	$1,348.6	$1,365.4	$1,186.8	$1,301.6
Warranty Reserve	$22.0	$16.0	$15.9	$16.2
Warranty Reserve % of Sales	1.6%	1.2%	1.3%	1.2%

**Note that for the purpose of calculating the reserve percentage, we adjusted the 9/18 reserve balance down by the $9.1 million picked up in the Fiberon acquisition as the 9/18 quarter had very little contribution for Fiberon sales.*

We see that while the reserve percentage is below the year-ago-level, the 9/17 figure was unusually high compared to other quarters. Thus, we do not believe the company is materially under-reserved at this point and view the decline in warranty expense as simply an artificial benefit the year-over-year EPS growth rate from an easy comp.

Other Income Increase

FBHS reported other income of $9.6 million in the 9/18 quarter compared to just $2.2 million in the 9/17 quarter. The 2018 figure included $500,000 in restructuring charges along with $300,000 in defined benefit actuarial loss. Both were removed from the company's adjusted EPS amount. Likewise, the 2017 figure included a $1.3 million actuarial gain which was added back to adjusted EPS. Still, the $7.4 million difference was mostly due to hedge gains associated with the 9/18 debt issuance along with favorable movement of the ineffective portion of foreign currency hedging instruments. We believe the approximate 4 cps increase in other income should be considered a non-operational boost to adjusted EPS.

Acquisitions Have Driven Up Debt and Ended the Buyback

Recent EPS growth has benefitted significantly from FBHS aggressively buying back shares in the 3/18 and 6/18 quarters. We can see in the following table that the average diluted share count declined over 5% year-over-year in each of the last two quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Quarterly Cash Buyback	$0	$278	$325	$41
Average Diluted Shares	144.2	146.6	152.1	154.4
Year-Over-Year Decline	-7.5%	-6.4%	-2.6%	-1.5%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Quarterly Cash Buyback	$141	$5	$27	$62
Average Diluted Shares	155.9	156.6	156.2	156.8
Year-Over-Year Decline	1.1%	2.1%	0.3%	-3.8%

We can see in the following table just how much of recently-reported EPS growth has been coming from the reduction in the share count by comparing the growth in adjusted net income to the growth in adjusted EPS:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Adjusted Net Income	$134.4	$146.7	$85.1	$123.3
YOY Growth	4.1%	2.4%	1.9%	11.4%
Adjusted EPS	$0.93	$1.00	$0.56	$0.80
YOY Growth	12.0%	8.7%	5.7%	12.7%

Therefore, the fact that the company had to discontinue the buyback after the 6/18 quarter due to debt incurred in the Fiberon deal is concerning. The following table shows trailing-twelve cash flow figures for the last three years ended 9/30:

	9/30/2018	9/30/2017	9/30/2016
T12 Operating Cash Flow	$591	$623	$532
T12 Capex	$176	$139	$148
T12 Free Cash Flow	$415	$484	$384
T12 Dividends	$115	$107	$96
Dividend % of FCF	29%	25%	25%
T12 Net Stock Repurchases	$644	$236	$399
Cash After Buyback	-$344	$141	-$111

The dividend consumes less than 30% of free cash flow and the discontinuation of the buyback will leave the company with about $300 million of cash flow after the dividend to reduce debt. However, FBHS currently has net debt of approximately $2.1 billion compared to trailing-12 EBITDA of $820 million, or about 2.6 times. This is not daunting, but it will still likely require the company to channel much of the excess cash flow towards debt reduction in the foreseeable future.

In addition, management has stated that it is actively eyeing acquisitions, so further jumps in the debt load are quite possible. While there is certainly no obvious reason to expect a dividend cut, we could see the dividend growth rate begin to slow, especially in the event of more debt being taken on to fund a large deal.

Regardless, more massive share buybacks do not appear to be in the cards in the near future which will result in the loss of a significant tailwind to EPS growth after the next two quarters.

Receivable DSOs

The following table shows accounts receivable days (DSO) for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$1,380.8	$1,429.0	$1,254.6	$1,382.5
Accounts Receivable	$635.4	$657.5	$631.5	$555.3
Sales YOY growth	2.4%	4.7%	5.7%	6.2%
Accounts Receivable YOY growth	6.8%	10.4%	11.8%	0.8%
Accounts Receivable DSOs	42.0	42.0	45.9	36.7

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$1,348.6	$1,365.4	$1,186.8	$1,301.6
Accounts Receivable	$594.7	$595.7	$564.9	$550.7
Sales YOY growth	5.4%	5.2%	7.3%	6.3%
Accounts Receivable YOY growth	4.6%	4.6%	7.5%	9.6%
Accounts Receivable DSOs	40.2	39.8	43.4	38.6

We are not alarmed by the 1.8-day year-over-year increase in DSOs in the 9/18 quarter. The company disclosed that the 9/18 receivables balance included $56 million of receivables from the Fiberon acquisition while the quarter had virtually no revenue from Fiberon. This accounted for all of the observed increase in DSO in the quarter.

However, we do think it is worth noting that both the 3/18 and 6/18 quarters saw DSO increases of 2.5 and 2.3 days, respectively. Such jumps are unusual for FBHS and we will continue to monitor the trend in receivables in future quarters.

Intangible Impairments

FBHS took a $27 million impairment charge in the 9/18 quarter to write down the value of an indefinite-lived tradename in the Cabinet segment. In addition, the company disclosed that further reduction in estimated tradenames could trigger future impairments with carrying values of $189.9 million. It is worth noting that goodwill and intangibles amount to $3.4 billion of the company's assets versus an equity balance of $2.2 billion. FBHS has already written down roughly $400 million in goodwill in the last few years.

Boston Scientific (BSX) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	NA

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

We initiate coverage of BSX with a rating of 4- (Acceptable)

BSX reported EPS of $0.35 in the 9/18 quarter which was a penny ahead of the consensus estimate. Management also stated in the conference call that EPS "include[d] approximately $0.02 of negative FX impact, which is $0.01 to $0.02 greater than our expected $0.00 to $0.01 headwind at the time of guidance." However, management also noted that the tax rate of 5.3% was considerably lower than the forecasted 13-14% range due to "greater clarity related to the tax reform and its impact on our tax structure." We estimate this added about 2.5 cps to earnings in the quarter. Adjusted for these factors, the quarter appeared to be a slight miss. Guidance for full-year 2018 was narrowed to $1.38-$1.40 from the previous $1.37-$1.41.

We saw a few minor items in the company's results that are worthy of note:

- The company maintains accounts receivables factoring programs in several European countries as well as with a Japanese bank. Receivables days of sale (DSO) based on receivables remaining on the balance sheet have been tracking relatively steadily, as have DSOs calculated on outstanding receivables derecognized under the factoring program. This alleviates concerns that the factoring program could be masking a problem with growing receivables or providing an unsustainable boost to recent cash flow growth. However, we do note that growth in Yen-denominated factored receivables has significantly outgrown the other components as well as the growth rate in Asia Pacific sales. While difficult to draw a solid conclusion with the available data, this trend should be monitored in upcoming quarters.

- The allowance for bad debts as a percentage of receivables has fallen to 4% from about 5% a year ago. We do not view this as being a material concern at this point as it would only take about a penny per share charge to restore the reserve to year-ago levels.

- Accounts payable days (DSPs) jumped by over 7 days over the year-ago quarter. We believe this is simply a timing issue and are not overly concerned at the moment.

Receivables Factoring Program

BSX maintains receivables factoring programs in several European countries as well as a factoring agreement with a Japanese bank. Receivables are sold to third parties without recourse to the company. The receivables are derecognized from the balance sheet at the time of sale. The following table shows receivables on the balance sheet, outstanding derecognized receivables, and the calculation of adjusted days of sales (DSO) for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$2,393	$2,490	$2,379	$2,409
Accounts Receivable	$1,580	$1,587	$1,580	$1,548
Derecognized Euro Receivables	$158	$161	$178	$171
Derecognized Yen Receivables	$194	$216	$219	$157
Total Derecognized Receivables	$352	$377	$397	$328
Adjusted Receivables	$1,932	$1,964	$1,977	$1,876
Accounts Receivable DSO	60.2	58.2	60.6	58.6
Factored Receivable DSO	13.4	13.8	15.2	12.4
Total Adjusted DSO	73.7	72.0	75.8	71.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$2,222	$2,257	$2,160	$2,191
Accounts Receivable	$1,470	$1,444	$1,429	$1,472
Derecognized Euro Receivables	$167	$165	$156	$152
Derecognized Yen Receivables	$162	$157	$154	$149
Total Derecognized Receivables	$329	$322	$310	$301
Adjusted Receivables	$1,799	$1,766	$1,739	$1,773
Accounts Receivable DSO	60.4	58.4	60.4	61.3
Factored Receivable DSO	13.5	13.0	13.1	12.5
Total Adjusted DSO	73.9	71.4	73.5	73.8

Both balance sheet receivable DSOs and factored receivable DSOs have been trending relatively steadily on a year-over-year basis. This alleviates the concern that the factoring program is masking an increase in credit terms by moving the receivables off the balance sheet. In addition, there does not appear to be a rapid acceleration in the use of factoring that is providing a large, temporary boost to operating cash flow growth.

However, we do observe that growth in Yen-denominated factored receivables has outgrown both Euro-denominated receivables and balance sheet receivables. In addition, the 20% year-over-year growth in Yen-denominated factored receivables far outpaced the 6% growth in Asia Pacific sales. Without Yen-denominated sales and total Yen receivables, it is difficult to reach a conclusion that Japanese sales benefitted from the aggressive extensive of receivables. Still, the trend is worth noting and will be more of a concern if it continues into future quarters.

Decline in Bad Debt Percentage

While it is not yet a major concern, we note that BSX's allowance for bad debts has fallen to 4% of receivables compared to just over 5% a year ago.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Beginning Allowance	$63.0	$67.0	$68.0	$81.0
Charged to Expenses	$6.0	$4.0	$4.0	$0.0
Utilization of Allowance	-$4.0	-$8.0	-$5.0	-$12.0
Ending Allowance	$66.0	$63.0	$67.0	$68.0
Allowance % of Gross Receivables	4.0%	3.8%	4.1%	4.1%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Beginning Allowance	$74.0	$75.0	$73.0	$75.0
Charged to Expenses	$9.0	$2.0	$3.0	$4.0
Utilization of Allowance	-$2.0	-$3.0	-$1.0	-$6.0
Ending Allowance	$81.0	$74.0	$75.0	$73.0
Allowance % of Gross Receivables	5.1%	4.7%	4.8%	4.6%

It would take a charge of only about a penny per share to increase the reserve back to year-ago levels, so this is not a material issue yet but is worth monitoring in future quarters.

Accounts Payable Days Jumped

BSX's accounts payable days (DSPs) jumped significantly in the 9/18 quarter as seen in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$672.0	$739.0	$672.0	$674.0
Accounts payable	$453.0	$403.0	$404.0	$530.0
COGS YOY growth	$0.1	$0.2	$0.0	$0.1
Accounts payable YOY growth	$0.2	$0.1	$0.1	$0.2
Accounts payable DSPs	61.5	49.8	54.9	71.8

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$637.0	$632.0	$650.0	$618.0
Accounts payable	$371.0	$376.0	$376.0	$447.0
COGS YOY growth	$0.1	$0.0	$0.1	$0.1
Accounts payable YOY growth	$0.2	$0.3	$0.6	$1.1
Accounts payable DSPs	53.1	54.3	52.8	66.0

Payables levels are not alarmingly high overall, and we have not seen any mention of the cause of this jump. We are not especially concerned by the increase but will continue to watch the payables trend in upcoming quarters.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

Disclosure

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