BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Lennar Corporation (LEN) - Risk Factor Report/EQ Rating 4- (Acceptable)

Lennar (LEN) had a busy 2018 when it acquired CalAtlantic and began refocusing on its core homebuilding business. As a result, it sold its title agency, title insurance carrier, real estate brokerage, and its asset management platform that traded mortgage-backed securities known as Rialto. **The funds received are being used to retire debt and repurchase shares. That essentially leaves Lennar with a business that is cutting costs through those sales and also completing the combining of the acquired overhead staff. SG&A costs are down about 70bp as a percentage of revenues.** The debt figure is $8.5 billion, but largely fixed and with a reasonable maturity schedule that is $740 million - $1.3 billion annually over the next 3 years. Free Cash Flow is running well above that figure.

We do not see the remaining joint venture/affiliated companies as overly risky. In fact, we like the move into multi-family projects which give Lennar a hedge against traditional homebuilding while still being involved in essentially the same activity. **Pricing power and**

volume gains have been very strong of late, but we are concerned that recent results may represent the perfect scenario. The company noted that weakness in sales in late 2018 led to greater sales incentives to maintain buyers and move inventory. That is why it gets a minus rating – some evidence exists that Lennar may not have completely smooth sailing of double-digit gains in units sold and mid-single-digit gains in pricing may be tougher to achieve within a couple quarters. The company itself withheld 2019 guidance until the picture clears more from 4Q18.

The stock is only 6.6x trailing EPS adjusted for the gains and divestitures. We do not foresee a market anywhere close to 2006 as demand has only recovered to long-term equilibrium and volume is still growing. (See our Housing Primer report from last week for more information.) However, we did want to outline the key accounting issues and operating risks/opportunities at Lennar and start following it:

- **Lennar has a sizeable exposure to California both for units sold, pricing, and percentage of total business. It has less exposure to Texas. The company reported that 4Q18 saw unexpected weakness in California and it required higher incentives to move inventory – Negative.**

- **Despite hefty price increases, Lennar is seeing gross margin squeezed from rising land, labor, and materials costs. We think interest rates rising will also pressure costs as LEN capitalizes interest expense into inventory.** Interest rates also make customer payment sensitive and can cause them to trade down on some home extras and hold the line on pricing. **– Negative.**

- **Sales incentives have been falling and the company took advantage of a drop in lumber to rework its buying commitments and save money on homes under construction. It also made efforts to dramatically cut unsold inventory. Overall this is a Positive** and should be for early 2019. It only becomes negative after that because how does this improve further?

- **Inventory is a $17 billion asset and is checked for impairment often. Impairment tests involve discounting projected cash flows at 20% compared to carrying costs. Not having unsold inventory is a positive, having rising prices is a positive, having rising volumes is a positive – all that has translated into very minor impairments in recent years.**

- **Inventory could see some larger impairments if price increases become more difficult to realize as building costs are still rising. This could also happen if sales incentives increase. Probably not a first half 2019 risk at all – but could become a larger issue to follow.**

- **VIEs related to homebuilding exist to control land and lots. Lennar has 4 years of land available now. It intends to focus on moving more land off balance sheet and free up cash. The maximum exposure here is small and does not worry us. The land value is 3.6x the debt. The losses on the VIEs are minimal too and we see them as a cost of doing business and maintaining flexibility – Neutral.**

- **The Multifamily VIE has several interesting benefits. It allows Lennar to pull income forward from being 100% backloaded. It also allows it to earn income in multiple ways** – building the property, managing the property, and pro rata share of income. **Apartments should move counter to homebuilding and give Lennar a small hedge.** Impairment tests here have multiple sources of cash flow including the eventual sale of the property. **Depreciation lowers the carrying value at the same time higher rents may be boosting the market value – making impairment less likely – Positive.**

Geography Appears More Focused on California than D.R. Horton

It is tough to make a good geographic comparison to DHI because the companies include different states in different homebuilding regions. Also, Lennar changed its grouping recently to pull states out of the East and into the Central, make Texas separate and out of the Central, move other states from Central to the West, and add new states to the West.

The Western States for Lennar are 31% of volume vs. 24% for D.R. Horton. Texas is 16% for Lennar vs. 24% for D.R. Horton which also includes Oklahoma and Louisiana in that region. What is clear is Lennar has enjoyed comparable volume growth except in 2017 and much stronger pricing gains. D.R. Horton was posting volume gains of 13%-14% and pricing gains slowed from 2% to 0% last year:

Lennar	2018	2017	2016	2015
Volume	11%	11%	9%	16%
Pricing	10%	4%	5%	6%

By region, Lennar is still seeing some of its strongest growth in the West for both volumes and price where D.R. Horton was posting negative pricing last year:

Lennar

Volume	2018	2017	2016	2015
East	11%	16%	8%	16%
Central	21%	3%	n/a	n/a
Texas	-1%	7%	10%	9%
West	16%	9%	9%	27%

Pricing	2018	2017	2016	2015
East	7%	6%	2%	4%
Central	-2%	-3%	n/a	n/a
Texas	7%	4%	7%	9%
West	13%	6%	6%	6%

In 2016 and 2015, Lennar's Central unit was Texas, Arizona, and Colorado. That became only Texas after that, and Arizona and Colorado were moved to the West unit. Florida is in the east as opposed to Southeast for D.R. Horton

D.R. Horton

Volume	2018	2017	2016	2015
Southeast	11%	17%	20%	27%
Southcentral	13%	8%	7%	27%
West	15%	8%	5%	27%

Pricing	2018	2017	2016	2015
Southeast	1%	1%	1%	5%
Southcentral	0%	4%	4%	9%
West	-2%	5%	6%	3%

On the 4Q18 call, Lennar announced that California became a source of weak demand and that while many areas had bounced back beginning in 2019, California continued to lag according to President Jon Jaffe:

> *"We saw stability at the beginning of the quarter and then that sort of softened as it went through the quarter and at the higher price point, <u>you saw the greatest weakness. Clearly, we saw the greatest differential in absorptions and the higher-</u>*

price California coastal markets, so the Bay Area, Orange County, even to some degree the Inland Empire, which was pretty hot market saw the effect of what was happening in the coastal markets. Those same coastal markets also affect some market that benefit from them like Sacramento or Reno, which typically benefits from people move down the Bay Area, so there was a trickle-down effect to slow absorption pace in those markets. Seattle, which was really strong market saw some pullback as well. So those were the weaker markets."

"First, simple on the government shutdown, we've not seen any impact from that to the market in the DC area. Relative to California, as I mentioned earlier, we've seen, I think, the biggest delta in change in absorption pace. So, as we saw towards the end of the fourth quarter, more incentives to sell homes that will be delivered going forward to those stimulate the market given the nature of that magnitude of change."

"No, I wouldn't say it's better, I'd say it's probably still lagging a little bit. So firmer than it was, but still as -- on a comparison basis, not as healthy yet as the rest of the country."

We think Lennar has more geographic risk than D.R. Horton with greater exposure to California and less toward Texas. We also think it is more dependent on pricing to drive earnings. We would look at this as a sustainability of trend question – "How long can Lennar sustain large pricing gains in what has shown signs as being a weaker market?"

Pricing Increases Are Key to Lennar Earnings Too

We believe this is a larger risk factor for Lennar as well. The company has enjoyed higher pricing gains overall, and yet its gross margins are declining:

	2018	2017	2016
Gross Margin	21.8%	22.1%	23.0%
Price Hike	10%	4%	5%

There was a purchase accounting adjustment that wrote up inventories at Cal-Atlantic and effectively boosted Cost of Goods Sold by 220bp in 2018. We adjusted that issue out in the 21.8% gross margin.

"Gross margins on home sales were $3.7 billion, or 19.6%, in the year ended November 30, 2018, compared to $2.4 billion, or 22.1%, in the year ended November 30, 2017. The gross margin percentage on home sales decreased compared to the year ended November 30, 2017 primarily due to the backlog/construction in progress write-up of $414.6 million related to purchase accounting adjustments on CalAtlantic homes that were delivered in the year ended November 30, 2018, which impacted gross margins on home sales by 220 basis points. In addition, there was an increase in construction costs per home, partially offset by an increase in the average sales price of homes delivered.

Gross margins on home sales were $2.4 billion, or 22.1%, in the year ended November 30, 2017, compared to $2.2 billion, or 23.0%, in the year ended November 30, 2016. Gross margin percentage on home sales decreased compared to the year ended November 30, 2016 primarily due to an increase in construction and land costs per home, partially offset by an increase in the average sales price of homes delivered."

If gross margin is falling amid some hefty price hikes, what if the price hikes don't continue at past rates? Some of the price hike in 2018 was due to adding CalAtlantic to the mix with higher priced homes. If we multiply the units sold by the average selling price per home in 2017 and 2018, we get price hikes boosting revenue by $1.64 billion. **Let's cut that in half and give 2018 a 5% price gain – more in line with prior years – it's still $800 million in higher revenue largely flowing to gross profit. Even assuming 20% of that higher gross profit was lost to commissions and upgraded materials that wouldn't have impacted costs either, that's still $640 million pretax or just under $500 million net of taxes from price increases. Adjusting for one-time items, earnings at Lennar were $2.1 billion. Price hikes are a big part of earnings.**

The company is forecasting over 50,000 units sold in 2019, up more than 10% from 45,563 in 2019. If pricing growth starts to lag, it becomes a bigger problem. Lennar is already reporting gross margin squeezes with very sizeable price hikes, so we see this as a bigger risk than at D.R. Horton too.

Three other variables also come into play here: Interest Rates, Sales Incentives, Cost Pressures. As we noted in the Housing Primer report, we are less concerned about 50-100bp of interest rate increases slashing home demand. However, buyers could push back on the rising monthly payment by downgrading finishes, opting for cheaper fixtures, lower carpet prices, etc. That would pressure selling prices too.

Lennar also has some risk from rising interest rates boosting its costs to build homes – which requires it to raise prices at the same time the buyers may become more price sensitive. It capitalizes interest costs into homebuilding inventory and thus cost of goods sold. Much of the debt is fixed, but it does have credit lines that are variable rate and also add to this:

> *"Our business requires us to finance much of the cost of developing our residential communities. One of the ways we do this is with bank borrowings. At November 30, 2018, we had a $2.6 billion revolving credit facility with a group of banks (the "Credit Facility"), which includes a $315 million accordion feature, subject to additional commitments. The interest on borrowings under the Credit Facility is at rates based on prevailing short-term rates from time to time. Due in part to Federal Reserve Bank actions, short term interest rates increased during fiscal 2018 and are likely to increase during fiscal 2019. This increases the cost of the homes we build, which either makes those homes more expensive for homebuyers, which is likely to reduce demand, or lowers our operating margins, or both."*

Interest Capitalized	2018	2017	2016
In Cost of Homes Sold	$301.3	$260.7	$235.1
In Cost of Land Sold	$3.6	$10.0	$5.3
Other	$11.3	$7.2	$4.6
Total	$316.2	$277.9	$245.0
In Inventory	$412.5	$283.2	$276.8

Rising volumes of homes sold would account for some of this growth. But, interest capitalized in inventory at the end of the year is nearly $100 million higher (30% more) than what was expensed in Cost of Goods last year and Lennar's forecast calls for about a 10% gain in volumes in 2019.

On sales incentives – Lennar has been reporting declining sales incentives as a percentage of sales and actual dollars per home:

Incentives % Sales	2018	2017	2016
East	6.7%	6.7%	6.7%
Central	6.5%	6.8%	6.6%
Texas	9.1%	9.5%	9.7%
West	2.7%	2.9%	3.3%

Incentive per Home	2018	2017	2016
East	$24,500	$22,800	$21,600
Central	$26,800	$28,500	$28,600
Texas	$33,300	$32,400	$32,100
West	$15,500	$14,800	$15,600

Sales incentives lower revenue. By doing so, that lowers gross margin because the cost of goods sold is divided by a smaller sales figure. Lennar was already saying that incentives jumped in 4Q and early 1Q19:

> *"As we entered the seasonally slower fourth quarter, purchasers remained on the sidelines awaiting the market to adjust. Sales rates were slower than expected and increased incentives were needed to adjust pricing to entice a reticent market to transact."*

> *"So, as we saw towards the end of the fourth quarter, more incentives to sell homes that will be delivered going forward to those stimulate the market given the nature of that magnitude of change."*

More importantly, look at the West where Lennar has really shined. It's 31% of housing volume. But, with an average selling price of $553,000 vs. $331,000-$385,000 in the other divisions, the West is 42% of revenues. **It has also seen the larger price increases in percentage and dollar terms – yet it has the lowest sales incentives in percentage and dollar terms.** Now, sales are weaker there. We think this unit has the most potential to see higher sales incentives going forward and put pressure on prices. The recent results of the West being the best in every metric may not be sustainable for Lennar in 2019-20.

Cost Pressures remain in terms of labor and material prices. Lennar does not expect to see the labor cost situation improve much unless production rates decline for the industry. Most are still expecting to boost production in 2019 so we do not see that as an immediate cost relief measure. Moreover, as soon as homebuilders report falling volumes, the market will sell the stocks off. So, gaining some positive improvement in labor may have much larger negative implications for Lennar. However, lumber prices fell in late 2018 and the company reworked lumber purchases for many of the homes started in 4Q18 that will be delivered in 2019. The net impact will be a $3,000-$3,500 drop in lumber costs for homes built in early 2019. That's certainly a positive. However, the company expects to see higher labor consume a portion of those savings. Also, $2,000-$3,000 in higher sales incentives would also largely eliminate the lumber cost reduction.

In summary – we see lower price hikes as a key risk for Lennar. Its highest priced market has had the largest price increases and lowest sales incentives for years – yet that may have changed in late 2018. Gross margins were already falling despite large price hikes that in total accounted for a huge percentage of net income in 2018. If pricing gains are not as strong going forward and sales incentives are boosted – Lennar could have as much of 5%-10% of its expected earnings at risk in our view.

Inventory Risk of Write-down Is a Concern

We are not going to repeat the full discussion here like we did for D.R. Horton. But in summary, the size of a write-down in inventory is not limited to the amount currently invested in inventory. In determining an impairment, the company views the expected future cash flows from a project and the timing when they will be received against the current amount invested in the project plus the projected future costs to complete the job.

Thus, a company may have $1 million in inventory – which is largely land and construction costs and forecast that the project should produce $3 million in cash flows but still require $1.5 million of additional spending. That is the first key item – the size of an impairment can exceed the current inventory figure. The second key item is the inventory balance is huge – over $17 billion currently and finishing the work in progress will make that much higher. Thus, even 0.5%-1.0% hit on inventory impairments can become a significant number. Which brings up point three – the concern over unconsolidated Variable Interest Entities which includes land options is a valid concern – but inventory dwarfs the size of those accounts. Here is the maximum at risk in those areas:

2018 VIEs	Investments	Max Exposure
Homebuilding	$127.0	$188.9
Multifamily	$463.5	$710.8
Rialto	$197.0	$197.0
Total	$787.5	$1,096.7

Maximum exposure includes some debt and commitments for future investments. But inventory and future building costs could be well over 20-25x what these accounts represent.

In the case of Lennar, it uses a 20% discount rate to determine the present value of a homebuilding construction project. In the case of homebuilding the cash inflows are almost entirely recognized when the home is completed and title is transferred. They are backloaded. However, costs occur upfront and throughout the construction process. Thus, cash inflows are more impacted by the present value calculation than expenditures already made and future investments.

Cash inflows are influenced by the speed at which homes are sold – if delivery happens in 3 months instead of 4, the present value rises by about 1.4% on a 20% discount rate. If it's 5 months vs. 6 – the change is 1.7%.

Cash inflows are also influenced by sales incentives and other pricing issues. If pricing falls or incentives need to increase – then cash inflow forecasts would be pushed down. If pricing is strong or incentives decrease – then cash inflow forecasts should rise.

Spec homes and model homes would also influence the cash inflows and timing. Lennar is always looking to put a home under contract sooner than later and reduce this risk of having a completed home on the books that is not sold. An unsold home is still subject to a longer delivery period or potentially higher discounts, both of which could reduce cash inflows.

So where does Lennar stand on the revenue side? They reported on the 4Q call that they made a big push to sell inventory because they could see some signs of softness in the market. They ended the year with only One Unsold Property per community currently being built. Quite frankly, that is fantastic! So near-term risk of a timing issue from completed unsold homes is essentially zero. Going forward, it probably will not fall further at this point, but would have a long way to go to become an issue.

We know greater incentives were offered and some pricing pushback was seen in California. However, homes were sold. The pricing and incentive concerns may not make much of an impact in the next two quarters either.

On the cost side, the company is still warning of labor and land costs driving up costs to build. It was complaining about materials costs rising faster than revenues too – but reworking some of its lumber purchases is expected to help reduce that pressure by $3,000-$3,500 per home in the current construction backlog.

Much of the immediate situation would already be accounted for in the year-end inventory impairment tests and the write-offs remain very small:

Inventory Impairments	2018	2017	2016	2015
In Cost of Homes Sold	$31.3	$13.9	$-	$8.1

We do not see much risk of impairments through the next couple of quarters. However, as we noted above, we think costs will continue to rise and we are uncertain how much more sales prices can keep rising at past rates. To make a material impairment, increases in pricing would likely need to slow to 1%-2%. The market isn't there yet. At a period when pricing is still slightly positive, the cost side could still be growing much faster and trigger a larger impairment.

We do not see the current housing market as a bubble like 2006 when companies started to experience falling unit sales and falling pricing. So as far as a catastrophic situation – we do not see that as a realistic forecast at all for some time at Lennar.

Non-Consolidated VIE for Homebuilding

These are primarily a way to control land and lots off the balance sheet. Currently, Lennar owns about 200,000 lots, which is about 4-years supply. That should be a positive if land prices are increasing as it controls a key input cost of homebuilding. Going forward with new purchases, the company would like to swing from about 25% of land being held in JVs to about 40%. None of that alarms us.

The current nonconsolidated entities are producing losses as they wait for land sales. One of them - Five Point Holdings - has an incentive deal for a bonus on land sales if the homes ultimately built there and sold exceed gross margin targets. In the meantime, these JVs are losing money and Lennar is recording its pro rata share:

Homebuilding VIEs	2018	2017	2016
losses	-$91.9	- $61.7	-$49.3

Impairment tests are similar to how Lennar conducts them on other similar assets. Discounted cash flows are used and comparing trends in land valuations. We view this area for what it is, a way to ensure land is available to support the homebuilding operation. Losses are a cost of doing business and having more control of land in an off-balance sheet manner. Given the losses, we can envision a write-down, but as noted above – the VIE

exposure here is not that big at $189 million. The debt is also not that high at the homebuilding JVs - $1.2 billion of debt against $4.3 billion in land.

The Multifamily Portfolio

Part of the Lennar's refocus on homebuilding was also keeping its investments in building and owning apartments. In years past, apartments were built and sold. In general, these run a bit counter-cyclical to homebuilding so owning apartments is a good hedge. If home-buying slows, more people rent. If home prices get too high, more people rent.

While the company does not bring it up, owning these properties would give Lennar similar benefits that Starwood Property Trust receives due to depreciation. In the case of Starwood, it is structured as a REIT and must pay out a high percentage of its income to unitholders. Depreciation lowers income and thus the mandatory payout, which allows Starwood to retain more internally generated funds for reinvestment. For Lennar, depreciation reduces the tax bill and effectively boosts cash flow. Also, think about the targeted advertising and early credit review for a potential home-buyer from a current tenant.

In the case of homebuilding, Lennar recognizes costs as incurred, but revenue is not recognized until the buyer takes title. Thus, **homebuilding has income back-loaded** assuming a 6-month period of taking control of the land, building a $300,000 home, and transferring title – it may look like this:

Homebuilding	1 month	2 months	3 months	4 months	5 months	6 months	total
Revenue	$0	$3,000	$0	$0	$0	$297,000	$300,000
Costs	$50,000	$20,000	$50,000	$60,000	$50,000	$10,000	$240,000
Profit	-$50,000	-$17,000	-$50,000	-$60,000	-$50,000	$287,000	$60,000

When Lennar builds apartments, it can pull income forward. It acts as the general contractor and can bill for revenues on the percentage of completion method. That means revenue is recognized as work is performed. For illustration purposes, let's assume 6-months to build a $2 million apartment complex with Lennar acting as a general contractor earning 20%:

Apartment Build	1 month	2 months	3 months	4 months	5 months	6 months	total
Revenue	$0	$400,000	$400,000	$450,000	$600,000	$150,000	$2,000,000
Costs	$250,000	$320,000	$200,000	$350,000	$300,000	$180,000	$1,600,000
Profit	-$250,000	$80,000	$200,000	$100,000	$300,000	-$30,000	$400,000

The accounting is more conservative on homebuilding – but percentage completion is not that aggressive either in this case. Lennar isn't building a one of a kind Space Shuttle or Aircraft Carrier over 10 years. It's building on a shorter time frame and doing similar work that it always does in homebuilding. In both cases, the numbers are simply shown for illustration only – they are not actual figures. The key points to focus on are that apartment building generates larger numbers than building several homes and the income and cash flow come in sooner.

In some cases, with apartments, Lennar is also the property manager/operator. It gets paid for that on a continual basis as well. It then shares in the income/losses on an equity basis for income. So, Lennar gets paid to build it, paid to operate it, paid a pro rata share of income from rents, and then can potentially earn a gain if the property is sold. Compared to homebuilding where the company (except in the case of a spec home) agrees to a set price to sell the home in advance and essentially is paid to build the house. In both cases – Lennar assumes some cost risk. If wages rise or raw materials rise, or there are delays or design changes – Lennar likely has to absorb that.

There is an impairment risk process that also is applied to the multi-family portfolio at a couple of stages. During construction, Lennar tests the expected cash flows discounted at 10%-20% against the investment already made and the costs required to complete the project. That is similar to the homebuilding test. After construction, Lennar tests expected cash flows from rent and management fees that are discounted against the carrying value.

The discount rate is lower than in homebuilding so that reduces the risk of a write-down. The cash payment for managing the property is more assured of coming in, so that lowers the risk of a write-down later. Finally, depreciation is lowering the book value of the property that the calculation is being compared to. As time moves forward, the odds of having a drop in estimated value below book value becomes less likely and impairment risk declines. Assuming the investors and Lennar sell the property later, they may well find that rising rents and reduced book value generate a material gain on the sale.

Also, of note for impairments, Lennar had investments in 22 multi-family properties at the end of November 2018. Of that total, 14 had no debt. When doing an estimated value for a

property, the debt would be deducted completely before valuing the equity and comparing that to the figure on the books. That also makes an impairment less likely in our view. Just using simple numbers, let's say a $1.0 million property is worth 5% less than originally thought – that's a $50 million hit against equity of $1.0 million. However, if the property was set up with $750 million of debt and $250 million of equity – that same $50 million hit, cuts the investment amount by 20%.

Overall, Lennar makes solid money from Multi-Family investments when looking at all the buckets.

Multi-Family Income	2018	2017	2016
% of income + gains on sale	$51.3	$85.7	$85.5
Mgt. Fees	$48.8	$53.8	$38.5
Gen Contractor	$14.5	$10.6	$8.5
Total Pretax	$114.6	$150.1	$132.5

Adding CalAtlantic diluted the earnings from multi-family and more of the properties were sold in 2018. However, this was 10%-13% of pretax earnings before CalAtlantic and 5% last year.

Overall, we believe this area adds quality earnings at little risk as Lennar gets paid first in a few areas. Also, there is no recourse debt and the bulk of properties have no debt. It also accelerates some income vs. homebuilding via management fees and general contractor income.

Rialto Risk May Be Contained

Rialto was a Variable Interest Entity for Lennar. It was an investment and asset manager platform to buy and trade mortgage securities. On November 30, 2018, the operations were sold for $340 million and Lennar recognized a $296.4 million gain. What remains of Rialto is $297.4 million in commercial mortgage-backed securities bought at a discount. These will likely run-off and/or be sold over time. The total investment exposure here is $197.0 million.

Lennar will lose other earnings that Rialto used to produce – roughly $25 million in recent years. However, the cash proceeds will retire some debt and save on interest expense. Also, the risk is unlikely to grow, and the run-off will lessen it going forward in our view.

Healthcare Services Group (HCSG)- 4Q18 Update

HCSG reported another quarter where it missed on revenues and announced that it beat on EPS. As usual, the company does not give enough details in its 2-page press release to fully see everything going on and we will need to wait for the 10-K to more accurately review the period. We are extremely skeptical of the beat because they announced a $15 million catch-up benefit adjustment for worker's compensation in the quarter. Without that, they missed handily.

The company also reported another $9 million bad debt charge and a $3 million expense for training managers. On top of all that, there remains no growth in revenue:

HCSG	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17
Revenue	$496.4	$506.9	$503.7	$501.8	$499.4	$491.4

During the quarter, its contract with Genesis was changed where Genesis will pay the food company directly and then pay HCSG to prepare food and operate the dietary program for the client. This is expected to cost $20 million in quarterly revenue with about $7 million hitting in 4Q18. Going forward, revenue will fall more.

Also, we still do not believe that the company is collecting receivables in any meaningfully faster way. It stated again this quarter that has moved 40% of clients to a much faster payment plan. Instead of 30 days, it's now 14 days or even 7 days for some. Receivables should be plummeting, and they are not. Here is what they report in the press releases:

HCSG	4Q18	3Q18	2Q18	1Q18	4Q17
Reported Net A/R	$341.8	$353.5	$343.7	$335.0	$378.7
LT Notes Rec.	$43.0	$45.9	$37.4	$38.8	$15.5
Total	$384.8	$399.4	$381.1	$373.8	$394.2

Already that looks to be showing little improvement, but it's even worse. The company is ramping up bad debt reserves that reduces those figures:

HCSG	4Q18	3Q18	2Q18	1Q18	4Q17
Reported Net A/R	$341.8	$353.5	$343.7	$335.0	$378.7
LT Notes Rec.	$43.0	$45.9	$37.4	$38.8	$15.5
Total	$384.8	$399.4	$381.1	$373.8	$394.2
Reserves	n/a	$48.6	$49.7	$48.9	$12.0
Total A/R	n/a	$448.0	$430.8	$422.7	$406.2

We need the SEC documents to see the bad debt reserves. They do say that there was a $9 million charge to bad debt in the 4Q18, so that at least has been added to reserves. We need the 10-K to see the rest. But if HCSG is now getting paid weekly or bi-weekly by 40% of its customers, then receivables should be lower than 90% of quarterly sales. Receivables have risen since this faster collection process started.

Something happened in 4Q too – perhaps more of the receivables have been written off? We say that because the company also reports an investment and interest income line on the income statement. This is largely interest earned on cash and notes receivable. This line went negative in 4Q:

HCSG	4Q18	3Q18	2Q18	1Q18	4Q17
Interest Income	-$4.2	$2.0	$1.3	$0.5	$1.6

We won't know until we see the 10-K, but that looks like non-cash income being accrued that was written off.

On expenses, HCSG has been touting that it will get to a 14% margin on direct costs. It posted 14.3% for 4Q18. However, adjusting for the $15 million benefit from worker's comp and the $9 million charge for bad debt expense – the margin becomes 13.2% - still below forecast - ($5.6 million in lower pretax earnings).

SG&A came in at 6.4% but had a $4.1 million benefit from deferred comp and $1 million in one-time banking fees. That makes it 7.1% vs. last year's 6.7%. Guidance is for 7%. (The adjusted 7.1% vs. reported 6.4% is $3.25 million in pretax earnings.)

The tax rate was abnormally low due to Worker Opportunity Tax Credits. Instead of 21%-23%, HCSG had a 9.9% tax rate for 4Q.

Add that all up, EPS came in at 28-cents vs. the reported 42-cents. Plus, that gives HCSG credit for adding back the bad debt expense as though that is a one-time item, which it clearly is not.

Clorox (CLX) EQ Update-12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	4-

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

We lower our earnings quality rating to 3- (Minor Concern).

CLX's EPS of $1.40 in the 12/18 quarter beat consensus by 11 cps. However, a noticeable increase in inventory causes us to reduce our rating from a 4- (Acceptable) to a 3- (Minor Concern).

Inventory days (DSI) jumped by more than 7 days over the year-ago period as seen in the following table:

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
COGS	$830	$885	$947	$868
Inventory	$578	$519	$506	$508
COGS YOY growth	2.9%	7.0%	5.8%	5.0%
Inventory YOY growth	17.0%	12.3%	10.2%	-0.4%
Inventory DSIs	63.5	53.5	48.8	53.4

	12/31/2017	9/30/2017	6/30/2017	3/31/2017
COGS	$807	$827	$895	$827
Inventory	$494	$462	$459	$510
COGS YOY growth	3.9%	3.0%	2.5%	6.0%
Inventory YOY growth	-1.4%	-0.6%	3.6%	10.9%
Inventory DSIs	55.9	51.0	46.8	56.3

Management attributed the increase in inventory to the Nutranext acquisition and a buildup in product for pre-launch.

> *"I would say the bulk of that [inventory increase] is Nutranext. Keep in mind Q2 last year Nutranext not one of our portfolio. So that's the bulk of the increase in inventory. And then because we have such a strong innovation pipeline in the back half of this year, we did pre-build in preparation for launching in innovation, so that explains a bulk of the rest of it."*

However, the Nutranext deal closed on 4/2/18. This means that our calculation of quarterly DSI for that quarter would not have been artificially inflated by much given that it would have reflected almost a full quarter of Nutranext cost of sales to match against the acquired inventory. Therefore, the 6/18 and 9/18 quarters would have only been impacted to the degree that Nutranext's business model incorporates a higher level of inventory balances relative to cost of sales than the rest of CLX's business. The approximate 2-day year-over-year increases seen in the June and September quarters is not alarming. However, the sudden 7.6-day increase in the 12/18 quarter looks very much out of trend. Thus, we are skeptical that the acquisition could have driven half of the observed increase in inventory witnessed in the 12/18 quarter. This could be a sign of an unexpected buildup in product which could lead to higher markdowns in the upcoming quarters.

ResMed (RMD) EQ Update-12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3-

We maintain our EQ rating of 3- (Minor Concern)

We noted last week that RMD's 12/18 quarter earnings beat of 7 cps was muted by a roughly 9 cps boost from a lower than expected tax rate. In addition, our review of the 10-Q turned up a couple of other items to note:

- The accruals for warranties fell from $4.6 million in the 12/17 quarter to $3.9 million in the 12/18 quarter. This was not material by itself, adding less than half a cent to EPS. However, the warranty reserve now stands at 3% of quarterly sales compared to 3.5% a year ago. To increase the reserve to the higher level would require about a 2 cps charge- not huge, but a potential minor earnings headwind going forward.

- RMD invested $25 million in equity investees in the quarter which was up from a historical run rate in the $2-3 million range. This amount relates to the company's JV with Alphabet's Verily unit. The investment is accounted for under the equity method as RMD has significant influence but not control, and it is not the primary beneficiary of the JV's activities. As we noted in previous reviews, the company has other investments in privately-held research institutions. The amounts invested in these joint ventures do not initially flow through the income statement. While common in the medical device and pharma industry, we view payments such as this as understating R&D expense to the extent RMD benefits from research conducted by these companies. The company recorded a $3.3 million loss associated with its equity investments in the quarter which we assume is largely related to the Verily equity investment.

- Receivables financing arrangements remain under control.

Lancaster Colony (LANC) EQ Update-12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3-

Upon review of LANC's 12/18 10-Q, we are maintaining our EQ rating of 3- (Minor Concern).

- We mentioned in last week's note that LANC's inventory DSI rose by 2.5 days over the year-ago quarter. We estimate that acquisitions accounted for about half a day of the increase. A 2-day increase is not overly alarming by itself, especially since the level is relatively in-line when compared to the last four December quarters. In addition, it is a noticeable moderation from the 5 day increase we cited in the 9/18 quarter. However, the fact that all of the increase came from a rise in finished goods makes it more concerning and is the main factor in us maintaining our 3- rating.

- Management disclosed that the $9.6 million write-down to the value of contingent consideration related to the 2016 Angelic acquisition was a result of a reduction in EBITDA forecasts for the business. Management determined that there was no impairment to goodwill in the quarter. However, the decline in the fair value of contingent consideration obviously clearly indicates a material decline in the fair value in the associated intangibles which would seem to increase the risk of a write-down in the future.

Initial Thoughts from 4Q Press Releases of Companies Covered Under EQ Review

Illinois Tool Works (ITW)

ITW reported EPS of $1.83, a penny ahead of consensus.

We need the 10-K to assign a final score, but we are leaning towards maintaining our 3- (minor concern) rating given the following observations on the quarter.

- Inventory days continued to climb year-over-year, jumping 5 days versus the year-ago period. Management attributed this to higher materials costs on the conference call. However, this is the fifth straight quarter of meaningful year-over-over year increases in DSIs. We also note that the company utilizes the LIFO (last in, first out) method of inventory accounting for about 20% of its inventories which has the effect of reducing the associated inventory balances in periods of rising costs.

- To the company's credit, it does not add back restructuring charges to its non-GAAP EPS numbers, but rather includes them in its guidance and discloses their impact on operating margins each quarter. Lower restructuring charges accounted for 20 bps of the reported 70 bps improvement in operating margin in the 12/18 quarter. However, management is forecasting 7 cps in higher restructuring expense in the 3/19 quarter.

- Management noted in the call that it is discontinuing its 6-year string of providing quarterly EPS guidance during which time it never missed an earnings estimate. This may make for more quarterly volatility as analysts have less to work with.

Church & Dwight (CHD)

CHD's 12/18 quarter EPS of $0.57 missed the consensus by a penny.

We will not produce a final score until after reviewing the 10-K and maintain our 2+ (Weak) rating.

- Accounts receivable days (DSOs) fell a little over a day versus the year-ago quarter. However, one of our concerns with CHD is the lack of quarterly visibility into its factoring program which makes receivables analysis difficult. The 10-K should add a little color. This lack of visibility is the main factor behind our 2 rating.

- Inventory days (DSI) rose by 3.5 days over last year's fourth quarter, the fifth straight year-over-year increase. We noted in our review of the previous quarter that the increase was focused in finished goods. This is another area we will be looking at when the 10-K comes out.

Zimmer Biomet Holdings (ZBH)

ZBH's adjusted EPS of $2.18 for the 12/18 quarter beat estimates by a penny.

- The company recorded a $975.9 million goodwill impairment related to its Spine and EMEA reporting segments. We noted in our review of the previous quarter that the company warned the fair value of its Dental unit goodwill was only 5% above carrying value.

- In addition, the company took a $171 million charge related to an unfavorable litigation settlement which we also cited in our review of the previous quarter.

- We await the 10-K to assess the impact of receivables factoring on DSOs and cash flow.

Fortune Brands (FBHS)

FBHS missed estimates in the 12/18 quarter, reporting adjusted EPS of $0.86 which was 7 cps short of the consensus. The company continued to cite weakening market conditions in its commentary.

- Inventory days (DSI) rose by almost 8 days over the year-ago period. The previous quarter saw a year-over-year increase of 5.5 days which we did not flag due to the Fiberon acquisition in the period which likely inflated the DSI calculation. However,

the acceleration in the increase in DSIs and the fact that the current quarter had a full period of cost of sales from the acquired business makes the observed increase in inventory more of a concern. Management cited a definite slowdown in market activity in the fourth quarter along with inventory reductions by its customers. Lower than anticipated revenue is likely a factor in the observed buildup in inventory which increases the risk that the company could have to result to discounting to move excess product.

- Accounts receivable days (DSO) growth flattened out to be even with the year-ago quarter.

- The company took a $35.5 million asset impairment charge in the quarter related to indefinite-lived trade names in its Cabinets segment. We noted management's warning of possible writedowns in our review of the previous quarter.

- We are waiting for the 10-K for review warranty expense detail and other items.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

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