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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

February 14, 2019 | www.btnresearch.com

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Ares Capital Corp. (ARCC) – 4Q18 Update

ARCC had a strong 4Q despite market volatility during the quarter. The company reported core EPS of $0.45 ahead of forecasts by $0.04. Assets at work increased and the company boosted its dividend again to $0.40 per share per quarter. It also added a special dividend of $0.08 that will be paid as $0.02 per quarter during 2019. The CEO highlighted several of the catalysts we listed in previous reports as working to boost results:

> *"With higher LIBOR, higher aggregate portfolio yields attained with the substantial completion of the American Capital portfolio rotation, and limited credit issues; we believe the company has reached a higher level of sustainable recurring earnings."*

The stock repurchase plan was expanded from $300 million to $500 million. The trend still looks very favorable to grow the earnings without raising new capital and in turn passing through more dividend growth on a base yield that is already 9.3%. We maintain a BUY recommendation.

- The assets on the balance sheet should continue to rise and drive Core EPS. The rotation of American Capital assets is largely over which boosted exited investments for many quarters. Floating rates still provide higher earnings if interest rates increase. The leverage ratio is rising but remains below goal.

- ARCC is by far the largest BDC and simply has less competition too than smaller BDCs and passively indexed funds or those that must be managed for liquidity.

- Asset quality is improving – volatility like that seen in 4Q pulls funds away from the market and shifts it to be more favorable toward lenders

- Investment portfolio continues to see strong EBITDA growth from underlying companies, along with floating rate terms, and largely first lien/senior secured terms

- Path to higher core EPS and Dividends over next 2-3-years looks doable. A rising 9.3% dividend with potential capital appreciation trading for book value should be appealing in our view

Investment Assets are Rising and Security Yields Exceed 10%

Since early 2017 when ARCC closed on the American Capital acquisition, it has been rotating out of the low/non-yielding assets that came with American Capital, realizing gains, and reinvesting into assets with better yield. The yield on the total portfolio has risen from 8.1% in 1Q17 to 9.0% in 4Q18. For the income-producing securities, the yield has increased from 9.1% in 1Q17 to 10.2% in 4Q18. That rotation made it tough to keep money at work as exits were often as large as new commitments. Plus, there was a lag between completing exits and putting money back to work. In 4Q18, the company announced the exits from American Capital are essentially done:

> *"Throughout the year, we used the strong demand for private assets to largely complete the rotation of the acquired American Capital portfolio, to monetize gains, and to reinvest the proceeds into our core assets. Our rotation of the American Capital portfolio is now largely complete, in what was a successful acquisition by any measure for our shareholders.*

Since our purchase of the American Capital portfolio at the beginning of 2017, we've generated investment income as well as $426 million of net realized gains on exited investments, which results in a 37% realized IRR from the transaction. Of the $2.5 billion portfolio acquired, only $683 million at fair value remains, most of which we consider to be core assets. At this point, we will likely provide less robust updates on American Capital as that story is largely complete."

And that has enabled net investments to finally grow:

	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
Gross Commitments	$2,709	$1,924	$1,619	$1,792	$1,506	$1,546	$1,973	$864
Exits of Commitments	$1,021	$1,914	$2,200	$1,342	$1,321	$1,644	$1,792	$836
Net change	$1,688	$10	-$581	$450	$185	-$98	$181	$28
Investments	$12,417	$11,220	$11,527	$12,199	$11,841	$11,456	$11,498	$11,407

The limit for BDCs is currently 1.0x Debt/Equity. They want to keep some cushion so an increase in loss rates on investments doesn't drive the ratio above 1.0x. Thus, 0.8-0.9x is a common goal. In June the new rules kick in where BDCs upper limit rises to 2.0x Debt/Equity.

With the heavy rotation of assets, ARCC was continually operating at a below target leverage ratio.

	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
Debt/Equity	0.73	0.63	0.64	0.73	0.70	0.67	0.70	0.67
Net of Cash	0.69	0.54	0.57	0.69	0.66	0.64	0.64	0.64

The company is still at the low end of its current target range before the new rules take effect. Thus, it is possible to grow the leverage range to 0.75-0.85x in the next couple of quarters. Ultimately, the company's goal is to operate in a range of 0.90-1.25x from mid-2019-2021. The key point is with the rotation over, more efforts can be made to keep money at work and generating returns. The second point is leverage is still below optimal levels and that should also continue adding to earnings.

The pipeline for future deals stands at $1.4 billion. That compares to $710 million after 2Q18, and $505 million after 4Q17. That bodes well for a rising portfolio size too. The company also noted that it is working on more buy and hold situations with large private equity players who look to lock up their financing and let the businesses grow for a long time as opposed to trying to flip them quickly. That also would bode well for slowing portfolio turnover.

Finally, while ARCC believes interest rates have paused for now, higher rates over time would help results. In the 4Q18, 97% of new investments were floating rate securities vs. exits that were 82% floating rate. The total portfolio stands at 85% floating, up from 78%-79% earlier in 2018. A few quarters ago, with a smaller portfolio and a lower percentage of floating rate securities, ARCC forecast that 100bp of higher LIBOR added 17cents to EPS per year. Given where the situation stands, that 17 cents should be a bit higher too.

Size and Flexibility Still Gives ARCC a Competitive Edge

We have highlighted that ARCC and STWD both benefit from years of banking regulations pushing banks out of many traditional areas of lending. Here was another reference to that on the last conference call:

> *"I'd love to engage in buy and hold deals with a couple of folks. We did one of those with a few of our competitors that was publicly announced, that entailed a $1 billion-plus type transaction. That in the old days is a bank deal, right. In this world, because it was a take private it was a three-handed club between ourselves and two other substantial players in the market."*

Looking at the full BDC market – ARCC is $7.3 billion in market cap. Of the remaining public market, there are only a couple over $2.0 billion and many are under $0.5 billion. Also, most BDCs need to raise equity capital to expand the investment portfolio. To issue equity, the stock needs to trade at or above book value – and very few do. The average EBITDA of the companies ARCC is investing in is now $99 million. That is up from $62 million a year ago.

Doing some rough math, let's say an investment has 4-5x of EBITDA in debt – that's basically $400-$500 million on an average ARCC company. Now, another BDC with an equity and market cap under $500 million leveraged 0.7-0.8x and wants a diversified portfolio – how much can they bring to a deal like this? Maybe $20-$25 million?

There are private BDCs that exist with larger asset managers that would be competitors. However, the bulk of the publicly traded ones, simply aren't large enough to compete with

ARCC. Also, ARCC has an edge over many of the passive and funds that can face redemption pressure:

> *"We are not a benchmark investor, and as a matter of practice we can largely avoid cyclical industries such as retail, homebuilding, media, broadcasting, and metals and mining. And in these types of competitive markets we can also use strong market demand to optimize our portfolio and exit some more difficult situations.*
>
> *We saw that when sentiment shifts and outflows occurs, as they did rapidly in late 2018, many funds, particularly retail and passive funds, are forced to sell to meet redemptions. Many retail funds and passive vehicles are structured to manage liquidity, and not necessarily credit. But we believe that the big negative move that we saw in December was largely a technical event. As a result, during the fourth quarter, the broadly syndicated loan market experienced price weakness, but the buy and hold middle market, where we are most active, demonstrated materially less price volatility."*

There are Signs that Credit Quality Is Improving Still

As the company noted, it can avoid cyclical areas. By focusing on larger deals, it doesn't see the same level of volatility that the smaller players do. If anything, volatility pulls money out of this area and shifts lending terms to be more favorable to the lender. It has seen the percentage of the portfolio that is first lien and senior secured rise of late:

	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
1st Lien Sr Sec.	72%	68%	67%	47%	72%	51%	59%	74%

Also, the companies in the portfolio continue to grow. The EBITDA at the companies that ARCC is invested with rose 5% in TTM for the 4Q and that is now over two years of 4%-7% growth rates.

ARCC is dealing heavily with companies it has experience with too. This should be companies it has studied for a long time and perhaps over business cycles. Also, these are companies that likely have grown during the relationship and are likely to turn to ARCC again.

"During 2018, we closed on 8 billion of commitments with 113 of our 172 commitments about 65% made to incumbent borrowers. We believe our incumbent position not only enables us to grow with our best companies, but it also results in enhance portfolio performance."

"We're also focusing on larger companies with more diversified business lines and stronger market positions. The weighted average EBITDA of transactions originated in Q4 was over $100 million."

Despite the larger portfolio, the non-accrual rate declined from 3.1% to 2.5% over 2018 and declined in dollar terms as well. The leverage rate for companies is 5.4x EBITDA. In focusing on credit scores 4 being the highest and 1 the lowest – 95% of the portfolio is rated 4 (9%) and 3 (86%).

ARCC Looks Well Positioned to Grow EPS and the Dividend

The changes the company has planned out have been working for them so far as the EPS has grown faster in the last couple of quarters. This is the result of converting non-income producing securities into income-oriented investments, more floating rate securities in a rising rate environment, and finally seeing the leverage ratio start to increase.

	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
Core EPS	$0.45	$0.45	$0.39	$0.39	$0.38	$0.36	$0.34	$0.32
Dividend	$0.42*	$0.39	$0.39	$0.38	$0.38	$0.38	$0.38	$0.38
Net Leverage	0.69	0.54	0.57	0.69	0.66	0.64	0.64	0.64
Portfolio	$12,417	$11,220	$11,527	$12,199	$11,841	$11,456	$11,498	$11,407

*Includes 2-cents special dividend to be paid quarterly in 2019

The company isn't stopping here. They hope to grow leverage a bit more in the first half of 2019 ahead of the regulation changes that allow it to boost leverage even higher. Remember the company has a considerable backlog of deals that are running over 2-3x levels seen in recent quarters. The plan remains in place as noted on the 4Q18 call:

"But look, our goal is, over a two to three-year period, generally to be able to take our leverage ratio well up over one, and we think that that improves to ROE, just as a reminder that our company improves our ability to continue to pay the existing

dividend, and we hope higher dividends without introducing material risk to the company less effective."

Getting to 1.0x leverage would involve borrowing another $2.4 billion to invest in securities. Our analysis in our initial report showed that every additional $500 million is worth about 3.3-cents in core EPS per year at a 5% interest spread or 4.2-cents in EPS at the 6% spread ARCC has been posting.

On top of that, while we are not going to predict interest rate moves, we would not surprised to see LIBOR rise by 100bp over the next two years. That would add 17-cents to EPS and given that much of their funding is fixed, may help push up the interest spread ARCC earns.

Plus, ARCC is planning to repurchase $500 million of stock over several quarters. The stock is over $17 and there are 426 million shares outstanding. $500 million should be worth 25-29 million shares. For easy math, we'll assume 26 million which is a 6% decline.

The quarters should show some lumpiness depending on market conditions and speed at which this happens. But right now, quarterly EPS is $0.45. Add 6% from buying back shares makes it $0.48. Having the portfolio increase by $2 billion would keep the leverage ratio at the low-end of the 0.90-1.25x leverage goal. An extra $2 billion deployed by the end of two-years would add another 3-4 cents in quarterly EPS and make the total $0.52. Assuming 100bp of higher LIBOR adds another 4-cents per quarter and boosts the total to $0.56. There would still be room to move closer to the 1.25x leverage goal and add another $2 billion to the portfolio.

This is why we see this as a compelling story. It's a company that had a flat dividend for years that absorbed a large acquisition. The large acquisition generated a 37% IRR. Earnings and the dividend have now started to grow and the stock is flat since the changes have become obvious and still trades at book value. EPS could be set to rise another 24% over two years after already rising 15% in the last two quarters. Investors would earn a 9.4% yield, plus another 0.5% yield in special dividends. Plus, the BDC's tax rules require it to pay out the bulk of its earnings so as earnings rise, so does the dividend. So, the dividend should also be rising.

The only news item – and it came up on the 4Q call – is during the transition of the American Capital portfolio, Ares Management reduced its fees collected from ARCC by $10 million per quarter to reflect that many assets were not producing steady income. Those waivers will end in 2019. That is basically 2.3 cents per share per quarter. The key point to remember is those do impact GAAP earnings – but not Core earnings being discussed here. Core EPS also removes gains and loss and capital incentive fees related to gains and losses. It is expected to reflect the underlying income and expenses produced by the portfolio, interest expense paid, and regular management fees paid. Gains and losses still impact book value as does dividends. Book value has been steadily rising and if the company buys back shares below book value – it should add to it as well.

Welltower (WELL)- 4Q18 Update

We maintain our SELL recommendation on WELL as it missed forecasts for FFO (Funds From Operations by 2-cents in the 4Q). We continue to believe this industry remains in trouble as Healthcare Services Group wrote off more bad debts last week and Brookdale Senior Living missed forecasts today.

WELL continues to not subtract capital spending from FFO, which we consider a problem as it is now responsible for a growing share of bills. This trend continues as more properties are converted to an operating partnership instead of triple net leases. To use a car analogy, Welltower has effectively gone from being paid 15-cents per mile to drive a car and turning the gas and maintenance bills over to a third party to now being paid 25-cents per mile and paying for its own gas and maintenance. Welltower is touting the increase in FFO from the higher 25-cent/mile revenue arrangement and leaving out some hefty and cash outflows from the equation.

Guidance assumes a modest 2%-5% FFO growth after a year in which FFO fell by 4.3%. The outlook also appears to use a smaller capital spending figure. We need to spend more time with this company and wait to see the 10-K report for some added figures. Also, we need to review Brookdale's news in more detail too and will follow up on this industry. It currently looks like a company projecting minor growth trading for over 20x 2019's net FFO with a flat dividend.

We will update this group and Welltower in particular more fully with the 10-K and a more reading on recent competitors and customers:

- FFO adjusted for capital spending does not give much comfort for the dividend or the valuation of the stock. The company has not earned its $331 million quarterly dividend in 3 of the last 8 quarters on a gross basis. Adjusting for capital spending, it may have earned the dividend only twice in 8 quarters. The company's operating model has changed – the way results are viewed needs to change too.

- Again – Where is the growth? Looking at the Senior Housing margins, the profit per unit, and cap rates, not much is pointing up here. Easy comps will soon lap other units.

The Mysteries of Funds From Operation

We have addressed this in the past, but WELL has transitioned from being essentially a triple-net lease company with no funding costs related to the management, maintenance, taxes, etc. of the property. In that case, looking at Funds from Operation is valid as it is essentially gross cash flow with no further capital outlays. The problem is Welltower is still telling investors to focus on gross cash flow – but it is now responsible for many of those operating costs and investments it was able to ignore in the past. Moreover, the gross cash flow increases because it is assuming more risk and operating expenses. So, investors, should wonder why the changes in the portfolio haven't led to FFO rising rapidly?

We showed this after the 3Q results. Profit per same store unit was $474,000 for 4Q18 in the Senior Housing Operating division while for Triple Net Leasing it was $310,000.

Units	4Q18	4Q17	4Q16	4Q15
Sr Housing	568	509	472	431
Triple-Net	361	426	400	446

WELL is expanding the more profitable area by converting lower profit units from Triple-Net to Senior Housing and the cash flow is falling? The company did dispose of a division two years ago and has pared back in other areas too. But, if the profits are growing and the Senior Housing model is a better way to go – why isn't FFO rising already? Instead, FFO was $4.21 in 2017 and $4.03 in 2018 and guided to be $4.10-$4.25 in 2019.

What is more astounding is WELL is responsible for capital spending at the growing Senior Housing unit with much of this recurring -- yet it is not being subtracted from FFO. **Investors are still using the older presentation model even though the core business has changed.**

Here is one area where we need the 10-K. The company breaks down capital spending on the cash flow statement into four items: acquisitions, capital improvements to existing properties, construction, and capitalized interest. WELL does not release its cash flow statement with the press release. We use the capital improvement to existing properties as the proxy for annual spending and it has been running about 12-15 cents per quarter:

($ 000's)	3Q18	2Q18	1Q18	3Q17	2Q17	1Q17
FFO	285.3	378.7	353.2	295.7	384.4	306.2
Maint Cap Ex	62.3	64.8	46.5	66.0	51.0	42.1
Net FFO	223.0	313.9	306.7	229.7	333.4	264.1
FFO/Share	$0.76	$1.02	$0.95	$0.80	$1.04	$0.84
Net/FFO/Share	$0.60	$0.84	$0.82	$0.62	$0.91	$0.72

Here's what we know for 4Q18 vs. 4Q17: FFO was essentially flat $382.8 million vs. $380.3 million. In 4Q17, the company spent $91.2 million on capital improvements to existing properties – there appears to be some seasonality where money spent is higher in 4Q and lighter in 1Q. But the $91.2 still looks high.

WELL reports that its maintenance spending was $31.7 million in 4Q18 and $22.4 million in 4Q17. Looking at last year's 10-K that looks too low. **This is important because the company pays a dividend of $0.87 per share per quarter. That is $330.6 million in dividend payments per quarter. Looking at the topline for FFO – the company is already NOT earning its dividend in many quarters.** In 4Q18, the $382.8 million looks adequate at an 86% payout ratio of FFO to the dividend.

However, subtract the capital spending to existing properties – WELL has never generated enough Net FFO to cover its dividend in the last two years. If the spending in the 4Q18 is above $50 million, they likely didn't cover the dividend last quarter either.

Guidance is for FFO per share of $4.10-$4.25 and only $0.33 in capital spending for existing property. We believe maintenance spending is likely to come in closer to $0.60 – which would let WELL cover the dividend, but at essentially a 100% payout.

Senior Housing Is Still Not Showing Growth

If the company is going to hit forecasts of even 2%-5% FFO growth, it likely needs its largest unit to show some gains. Unfortunately, we are seeing margin squeeze especially in compensation.

What we expected to see happen during the transition from triple-net to operating partner is occurring. Last year WELL was renegotiating triple-net leases, cutting rents, moving those properties into off-balance sheet JVs. As the problem children are removed from that division, the division shrinks, and the good performers are concentrated in the comps. WELL then touts the same-store comps as a basis for growth:

Comp NOI Gain	4Q18	3Q18	2Q18	1Q18
Sr Housing	0.6%	0.3%	0.1%	0.6%
Triple-Net	4.3%	4.2%	3.1%	3.0%
Outpatient	1.8%	2.1%	2.0%	2.9%
L-T Acute	1.4%	2.1%	2.3%	2.4%
	1.6%	1.6%	1.4%	1.8%

The hospital and skilled nursing units have also had portfolio changes. Their easy comps have lapped, and the same-store growth rates are dropping. As noted above, WELL dumped a large number of units out of Triple-Net and it wasn't the top performers. That has unleashed strong comps for that division, but that should be tough to maintain much longer. And look, it is the only area driving the overall same store sales figure up. Senior Housing has been squeezed hard in this area despite holding the number of units at 473 in the comps during 2018 despite the total number of properties rising to 568.

There is more revenue coming from Senior Housing than the other areas. That unit saw a minor tick up in occupancy from 4Q17, but occupancies are still down considerably over the last several years. Looking at 4Q18 to 4Q17, we don't see much happening here:

	4Q18	4Q17
Occupancy	87.2%	87.3%
Margins	30.2%	31.9%
NOI total	$251.9	$223.2
# Units	568	509
NOI/Unit	$443.6	$438.6

Margins are being squeezed and the only thing helping Net Operating Income is it appears the new additions were higher revenue properties. Total revenue per property rose 6.7% but net operating income per unit was up only 1.1%.

From a same-store sales comparison, there isn't much growth here at all. Revenues rose 2.7% but compensation was up 5% and consumed much of that. We also noticed that all operating costs increased except curiously – maintenance and repairs.

SSS	4Q18	4Q17
Occupancy	88.3%	87.9%
Margins	31.9%	32.5%
Rev/Unit	$702.0	$683.4
# Units	473	473
NOI/Unit	$223.7	$222.3

A 2.7% revenue gain produced 0.6% income growth.

Hanesbrands (HBI) 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 EQ coverage of HBI with a rating of 3- (Minor Concern).

Our initial review of HBI turned up a few items of concern.

- HBI maintains an accounts receivables securitization facility under which it sells trade receivables to a wholly-owned subsidiary to fund a financing conduit. The receivables remain on the balance sheet and financing cash flows are reported in the financing section of the cash flow statement which avoids distortion of the trend in receivables origination and operating cash flows.

- However, HBI also sells receivables to third-party financing institutions which does result in the removal of receivables from the balance sheet as well as providing a boost to operating cash flow. Unfortunately, the company does not disclose the outstanding balance of sold receivables, making it impossible to get a clear picture of the trend in receivables origination and the impact on operating cash flow. A sudden, 5-day decline in receivable DSOs in the 12/18 quarter appears to have given a substantial boost to operating cash flow which may have been a result of the timing of such receivable sales.

- Inventory days (DSI) jumped by 8 days in the 12/18 quarter which the company blamed on preparation for growing sales of its *Champion* brand. However, we note that the sizeable increase has appeared very suddenly and is focused entirely on finished goods. In addition, cotton prices have been declining sharply since summer, but the lower costs will not be fully reflected in the cost of sales until later this year due to FIFO accounting.

Accounts Receivable Securitization Program and Receivables Sales

HBI maintains an accounts receivable securitization program for short-term financing purposes as described in the company's 10-K:

> *"Under the terms of the Accounts Receivable Securitization Facility, the Company and certain of its subsidiaries sell, on a revolving basis, certain domestic trade receivables to HBI Receivables LLC ("Receivables LLC"), a wholly owned bankruptcy-remote subsidiary that in turn uses the trade receivables to secure the borrowings, which are funded through conduits and financial institutions that are not affiliated with the Company."*

Importantly, the receivables that have been sold to the financing subsidiary are reported with the rest of the company's trade receivables on the balance sheet. Therefore, reported trade receivables trends are not distorted by the program. Cash flows from borrowings and repayments of the securitization facility are reported in the financing section of the cash flow statement as follows:

12 mos ended:	**2018**	**2017**	**2016**
Borrowings on Securitization Facility	$213.336	$373.640	$238.065
Repayments on Securitization Facility	-$176.937	-$292.952	-$388.707

However, in addition to the securitization program, HBI also sells accounts receivable to third-party financial institutions. The company stated the following in its 2018 10-K with regard to its accounts receivable sales:

> *"The Company has entered into agreements to sell selected trade accounts receivable to financial institutions based on programs offered by certain of the Company's largest customers. As a result of the strong credit worthiness of these customers, the discount taken on these programs is less than the marginal borrowing rate on the Company's variable rate credit facilities. After the sale, the Company does not retain any interests in the receivables and the applicable financial institution services and collects these accounts receivable directly from the customer. Net proceeds of these accounts receivable sale programs are recognized in the Consolidated Statements of Cash Flows as part of operating cash flows. The Company recognized funding fees of $9,566 , $6,059 and $4,497 in 2018 , 2017 and 2016, respectively, for sales of accounts receivable to financial institutions in the "Other expenses" line in the Consolidated Statements of Income. The increase in funding fees in 2018 compared to 2017 was*

primarily due to the increase in LIBOR during 2018, which resulted in higher funding fees of $2,897."

Unlike the securitization program, the sale of accounts receivable would remove the sold receivable balances from the company's balance sheet and artificially distort the trend in receivables and consequently the calculation of days of sales (DSO). Unfortunately, the company does not disclose the outstanding amount of sold receivables which materially clouds the analysis of the company's revenue recognition as well as its growth in operating cash flows.

We know from the above disclosure that the discount the company paid to sell the receivables increased by more than 55% in 2018. However, the disclosure indicates that the bulk of this was due to an increase in LIBOR. The company does not give enough information to get a clear picture of how much the sales are impacting receivables and cash flows.

We do note that accounts receivables took an unusual decline in the fourth quarter as shown in the following table:

	12/29/2018	9/29/2018	6/30/2018	3/31/2018
Sales	$1,768	$1,849	$1,715	$1,472
Accounts Receivable	$871	$1,045	$974	$875
Sales YOY growth	7.5%	2.7%	4.2%	6.6%
Accounts Receivable YOY growth	-3.6%	3.5%	4.1%	9.3%
Accounts Receivable DSOs	44.9	51.6	51.8	54.2

	12/30/2017	9/30/2017	7/01/2017	4/01/2017
Sales	$1,645	$1,799	$1,647	$1,380
Accounts Receivable	$903	$1,009	$936	$800
Sales YOY growth	4.4%	2.2%	11.8%	13.2%
Accounts Receivable YOY growth	7.9%	4.9%	9.1%	10.9%
Accounts Receivable DSOs	50.1	51.2	51.8	52.9

After tracking very steadily, DSOs in the 12/18 quarter fell by 5 days from the year-ago period. In the conference call, management stated that its "focus on receivables and payables resulted in an eight-day improvement in our cash cycle versus last year." This was the only mention we saw with regards to receivables movements in the quarter. (We do note that the company took a $14 million charge to bad debt in the 9/18 quarter related to the Sears bankruptcy.)

We do not see evidence that the company sold enough receivables to mask an alarming rise in receivables origination. However, the sudden drop in DSO does make us wonder if at least some of the decline could be due to a large receivables sale at the end of the quarter that could have artificially boosted reported operating cash flow. We note that accounts receivable generated $166.8 million in cash in the 12/18 quarter compared to just $116.3 million in the 12/17 quarter. Reported cash from operations for the full year 2018 was $643.4 million versus $655.7 million in 2017. Without the incremental boost from accounts receivables, cash from operations for 2018 would have fallen to $592 million.

Inventory DSI Jump

HBI's inventory days (DSI) have risen year-over-year in each of the last two quarters after a long string of declines:

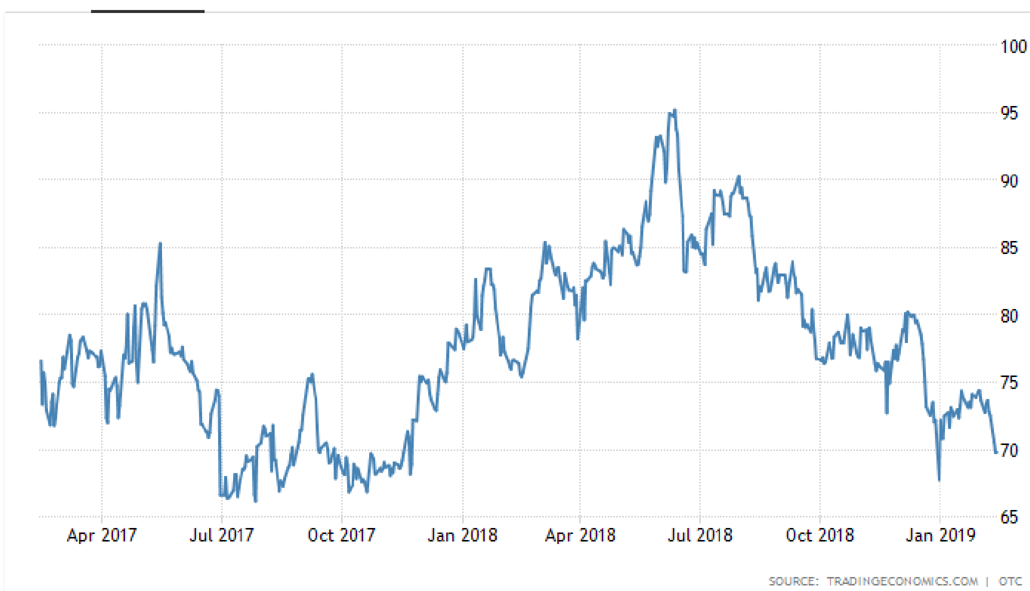
	12/29/2018	9/29/2018	6/30/2018	3/31/2018
Raw Materials DSI	9.2	10.8	11.9	13.8
Work in Process DSI	15.7	15.7	18.6	21.8
Finished Goods DSI	151.4	145.3	152.2	173.4
Total DSI	176.3	171.8	182.6	209.0

	12/30/2017	9/30/2017	7/01/2017	4/01/2017
Raw Materials DSI	11.6	10.6	12.4	15.1
Work in Process DSI	20.3	16.4	18.1	22.3
Finished Goods DSI	136.1	132.0	151.9	179.5
Total DSI	168.0	159.1	182.4	216.9

	12/31/2016	10/01/2016	7/02/2016	4/02/2016
Raw Materials DSI	12.4	12.1	14.7	19.4
Work in Process DSI	17.5	16.4	20.4	26.3
Finished Goods DSI	144.4	136.1	165.0	190.2
Total DSI	174.4	164.6	200.0	235.9

Management has indicated that the buildup in inventory is a result of "increased investments to support the global demand of our *Champion* products." What is important to note is that all of the increase in DSIs has come from finished goods. While total inventory DSI is over 8 days higher than last year's fourth quarter, it is only two days higher than the 12/16 level. However, the finished goods DSI is over 15 days higher than last year and 7 days higher than in 12/16. Meanwhile, raw materials and work in process DSIs have declined considerably.

To understand the increase in inventory, we need to look at trends in raw materials prices. Cotton is a key raw material for HBI and accounts for about 5% of the cost of sales. In addition, oil and other chemicals used in dyes are important. Interestingly, cotton prices have been in a freefall for the last few months:



Despite this, management has blamed higher costs for pressuring gross margins in 2018. Adjusted gross margin for the last eight quarters is shown below:

	12/29/2018	9/29/2018	6/30/2018	3/31/2018
Adjusted Gross Margin	40.1%	39.2%	39.1%	40.1%

	12/30/2017	9/30/2017	7/01/2017	4/01/2017
Adjusted Gross Margin	40.1%	37.8%	39.5%	40.2%

With regards to flat gross margin in the 12/18 quarter, the company stated in the conference call:

> *"Gross margin of 40.1% was consistent with prior year as the impacted input cost inflation, product mix and foreign exchange offset the benefits from acquisition contributions, synergies and price increases for certain Activewear products."*

Also, the company stated the following regarding the unusual improvement in adjusted gross margin in the 9/18 quarter:

> *"We increased gross margin by 140 basis points over last year. Favorable mix, driven principally by Champion, contributions from Bras N Things as well as the benefits from acquisition synergies and cost savings initiatives more than offset higher input costs."*

Management is forecasting a 50 bps improvement in gross margin in 2019 driven by price increases it is implementing in the first half of 1Q19 as well as a beneficial mix shift.

We know that the company does little in the way of raw materials hedging, but it can lock in cotton prices with suppliers to help shield itself from price moves. Also, keep in mind that FIFO inventory accounting ensures that raw materials prices do not impact the company's income statement for 6-9 months after purchase.

With all this in mind, we have the following observations about the recent inventory moves:

- The FIFO-related delay in realizing higher cotton costs in inventory means that the spike in prices experienced in the spring and summer of 2018 has still not run its course on the income statement. This points to continued pressure on gross margin in the next couple of quarters but could result in a tailwind in the second half of the year, depending on how well the 1Q19 price increases stick.

- The decline in raw materials DSIs may partly be from lower costs earlier this year, but also indicate that the company does not appear to be stocking up while raw materials prices are lower.

- The *Champion* brand has been growing as it rides the current sportswear fashion craze and the company's expansion of its own *Champion* retail stores. Therefore, the idea that inventory could be rising to prepare for future sales increases makes sense in principle. However, investors should keep in mind that innerwear (35% of sales, 22% of operating profit) was down over 3% in 2018. Therefore, the sudden increase in finished goods looks unusual. Further buildup should be viewed with caution.

Headcount reduction

HBI incurred acquisition and integration charges of $80.2 million in 2018, down from $190.9 million in 2018 related to several acquisitions taken over that time frame. Management indicated that it will take another $50 million in early 2019 which will wrap up the integration program. We will consider it a red flag if the company extends or announces new restructuring programs in 2019.

Ocean Yield (OCY NO, OYIEF)- 4Q18 Update

There are several positive items this week for Ocean Yield – key among them is a likely new contract for the FPSO. We are maintaining our neutral rating until that contract converts from an option to an actual deal, which could happen in May. We maintain our belief that the company can pay its dividend during 2019 but would need to resolve the FPSO situation – new contract or sale – to justify the current level longer-term.

- New Option for 15-year contract on FPSO with Aker, to work on a new field in Ghana after modification. This will also be a bare-boat charter, which means Ocean Yield will not be paying the crew and other operating expenses.

- The *Connector* has been idle since December 5 is expected to sign a new short-term contract this month. This is a seasonally slow period and Ocean Yield sees increasing demand for the vessel and will seek a longer-term contract at a higher rate soon.

- Payments on vessels with Solstad should resume in June 2019 – *Far Senator* started a new contract in January.

- Cash needs for the next 12-months are forecast to be lower than our original forecast

- Impairments for several issues all appear to be one-time in nature largely related to FPSO and decommissioning it from India

Potential New Deal for FPSO – under Option

Aker is the largest shareholder in Ocean Yield at 61.7%. Aker is an energy company and is developing a new field in Ghana. After several successful test wells, it intends to submit a long- term development plan for the fields to the government by the end of March. Part of their plan is expected to employ Ocean Yield's FPSO under a 15-year bareboat charter.

Aker has an option on the vessel until May 1 – that can be extended 30 days. In return, it will pay Ocean Yield $3 million for the option. If it is extended past May 1, the option payment is $50,000 per day or up to $1.5 million. Also, as a bareboat charter, Aker will be responsible for operating costs of the vessel – employees, fuel, maintenance. Aker will hire the employees on the FPSO through the May 1 option period. The total vessel operating expenses have been about $3 million per quarter for the FPSO. Those will transfer off Ocean Yield's income statement.

The FPSO will also need modification work done. That would begin if the contract is picked up. The cost could be as much as $230 million and Ocean yield expects to borrow that money for the investment using the contract and the value of the vessel. The contract would reflect the rising book value of the vessel $240 million + $230 million in modifications and maintain the same type of return in the 13%-15% ROE range. The vessel is currently debt free and could emerge as essentially 50% leveraged.

Actual work and oil production are expected in 2021 and that should add to the company's cash flow as that occurs. In prior years, the FPSO was producing about $115 million in EBITDA but had some sizeable debt payments, which netted cash flow of about $40 million per year for Ocean Yield. A rough estimate based on the discussion on the conference call would be the value of the FPSO would be $470 million earning 13%-15% or $60-$70 million in revenue. There would be no crew or operating costs so EBITDA should be $60-$70 million per year. Interest expense and debt payments would be in the $25-$30 million range and net cash flow could be about $30-$40 million per year.

That is a forecast based on one press release and a few comments in the conference call at this point. It would appear that if this option is exercised, the largest question mark surrounding Ocean Yield would be lifted.

The Connector's Outlook Is Brightening Too

4Q and 1Q are seasonally slower times for cabling and offshore work. Since its contract was prematurely canceled in 2017, the Connector has worked a series of short-term charters and also been idle for periods of time in 2017 and 2018. The last charter ended in early December. On the call, the company said it expects to announce a new short-term contract within a few days.

The goal is to wait for more of the offshore market to improve. That is happening. Solstad, Seadrill, Diamond Offshore are all announcing new contracts for rigs and support ships. The Aker deal in Ghana would be evidence of that too along with Brazil starting to drill again. Ocean Yield wants to sign a long-term charter for the Connector believes that time will come.

This is a vessel that was earning over $60,000 per day in the past or essentially $20 million per year. With a series of contracts for 1-5 months at lower rates followed by idle time – that has been essentially producing about one-third of its past cash flow.

It sounds like 2019 will start slowly for the Connector but it may finish the year with a brighter cash flow outlook. We are not going to speculate on timing, but the company did sound more upbeat about the future. The Solstad Charters also have been impacted by this market and as previously announced, Ocean Yield agreed to waive 6-months of charter rates on two vessels here. Solstad put one of those vessels on a charter in February. While this 6-month hiatus will cost Ocean Yield about $4.4 million in EBITDA in early 2019, the worst of the news in this area for the Connector and Solstad charters may be past the company.

The Cash Needs for 2019 Are Coming in Below Our Forecast

The company has funded the bulk of its capital spending needs at this point and we believe the cash needs for 2019 will come in below $350 million vs. our previous forecast of about $400 million:

The Dividend is $30.4 million per quarter	$121.6
Debt due is $190.9, but over $100 will refinance	$83.5
Interest expense incurred now will rise in 2019	$96.0
Remaining capital spending for new vessels	$19.0
Demobilization costs for FPSO (reserved)	$26.1
Total	$346.2

The company's largest portion of debt maturing is $107.4 million on the SBM Installer that is under fixed contract until 2025 with a floating rate after that. The company intends to refinance the debt on the vessel. Its remaining capital spending on new vessels has been financed too, leaving only $19 million in cash outflow. Demobilizing the FPSO out of India will be complete soon and the company has a reserve of $26.1 million remaining there – we assumed it would consume the entire amount.

Against this total, the receivables owed by Reliance to wind down the FPSO contract have been negotiated and Ocean Yield will receive $25.9 million. It has the $3 million payment from Aker coming. It also has $142 million in cash and liquidity available. That totals $170.9 million.

EBITDA in the 4Q has the FPSO charter out and came in at $70.8 million. There was $1.6 million in operating expense for the FPSO that will transfer to Aker. The quarter also had the Connector operating for two months – that will remain lumpy in 2019. The $70.8 + $1.6 gives them an annualized EBITDA of $290 million. From that, subtract the $4.4 million for 6-month deferral to Solstad and estimate a worse case for the Connector and take out another $5.6 million. That leaves the company with $280 million in EBITDA plus $170 million in liquidity or $450 million.

The recent delivery of a Suezmax tanker and the VLCCs coming this year in Q2 and Q3 will add to EBITDA as will the Chemical tankers that arrived in 4Q18 and only had a partial impact on last quarter's EBITDA. This further assumes no additional cash for the FPSO if the contract option is exercised. It also assumes another poor year for the Connector – where it produces one-third of past levels.

We're staying neutral because the company can limp along in this manner and see improvement throughout 2019 and into 2020 while maintaining the dividend. However, the FPSO deal is key to longer-term success in sustaining the dividend. If the option is not exercised, we would still question the current dividend's sustainability until the company finds a way to produce a higher cash flow figure or monetizes that vessel for cash.

Several Impairments are One-time and Appear to be Clean Up Issues

We are the first to attack charges as admitted mistakes. However, there is a difference in our view between announcing a write-down of an acquisition made 9 months ago and adjusting reserve accounts that relate to a decade old project. The company took several charges in the 4Q and the bulk of them relate to end of the FPSO's Indian project:

FPSO Goodwill Charge	$9.8
Write off of Contract A/R	$19.5
Boost in Demobilization Reserve	$9.1
Solstad related charge	$13.4

The deal in India lasted over ten years and involves oil and gas drilling and clean-up plus truing up long-term reserves. With no contract, the company wrote off the remaining goodwill on the FPSO. The vessel is still worth $240 million and is likely to be modified in a substantial way. With no cash flow coming in at the moment, the $9.8 million charge is reasonable and conservative in our view.

Reliance in India owed a collection of items relating to completing the contract. The two sides negotiated a $25.9 million cash settlement that will be paid shortly. The maximum amount that accrued on Ocean Yield's books over several years was over $45 million so in closing out that deal and speeding the collection, Ocean Yield wrote off the remaining $19.5 million of receivables related to contingencies.

Moving the FPSO involves some work on the site, unhooking all the cables and transferring the ship. The company has a reserve now of $26.1 million to deal with these costs after adding $9.1 million to the estimate. It also appears to make the $25.9 million cash payment coming from Reliance at worst case a wash. If the demobilization comes in under budget, it will produce net cash to the company.

So, the bulk of the impairments relate entirely to ending the FPSO contract and closing out the contingencies of that project.

The impairment on the two Solstad charters reflects the 6-month holiday on charter revenues. The reduced cash flow resulted in an impairment to the ship values. That's non-cash and we do not believe this has a material impact.

Mondelez Intl. (MDLZ) EQ Update-12/18 Quarter

Current EQ Rating*	Previous EQ Rating
2-	2-

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

We maintain our EQ rating on MDLZ at 2- (Weak).

After review of the 2018 10-K, we update our points of concern as follows:

- Factored accounts receivable in the 12/18 quarter were flat with the year-ago level on a days-of-sales basis, implying the acceleration of the use of factoring has faded. However, total adjusted receivable DSOs fell 5 days from the year-ago quarter which seems unsustainable. Movements in accounts receivable were a $257 million source of cash in 2018 compared to a $24 million ***use*** of cash in 2017 which illustrates how large a tailwind the company has been receiving from squeezing receivables.

- Accounts payable days rose by 5 days over the year-ago quarter but the margin of growth continues to narrow. With the company now taking three months to pay suppliers, we are skeptical of how much room for improvement is left from this source of cash flow growth. Movement in payables was for 2018 added $236 million to cash flow compared to $5 million a year ago.

- Inventory DSIs rose by 2 days over the 12/17 quarter, but the finished goods percentage flattened out which lessens our concern.

Accounts Receivable Factoring Declines, but Receivables Reduction Seems Unsustainable

One of our major concerns regarding MDLZ was its rapid expansion of receivables factoring which was providing a large boost to cash flow growth. The following table shows the calculation of total trade receivables and factored receivables days of sales for the last eight quarters. "Adjusted receivables" refers to trade receivables on the balance sheet plus receivables that have been sold but are still outstanding at the end of the period.

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Sales	$6,773	$6,288	$6,112	$6,765
Trade Receivables	$2,262	$2,732	$2,416	$3,113
Factored Receivables	$819	$769	$719	$866
Adjusted Receivables	$3,081	$3,501	$3,135	$3,979
Adjusted Receivable DSOs	41.5	50.8	46.8	53.7
Factored Receivable DSOs	11.0	11.2	10.7	11.7

	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Sales	$6,966	$6,530	$5,986	$6,414
Trade Receivables	$2,691	$2,981	$2,395	$3,035
Factored Receivables	$843	$650	$594	$630
Adjusted Receivables	$3,534	$3,631	$2,989	$3,665
Adjusted Receivable DSOs	46.3	50.7	45.6	52.1
Factored Receivable DSOs	11.0	9.1	9.1	9.0

On the bright side, year-over-year growth in factored receivables days of sales has leveled off, indicating the company has stopped accelerating the utilization of its factoring program. By itself, this would have taken away a significant tailwind to operating cash flow growth. However, we find it interesting that in the same quarter that the company cut back on factoring, its total adjusted receivables DSO fell by more than 5 days compared to the year-ago quarter (41.5 vs. 46.3). This could be an indication that the company accelerated the collection activity of its retained receivables during the quarter to offset the scaling back of factoring. We are skeptical that this sudden jump represents a sustainable rate of improvement. Keep in mind that accounts receivable was a $257 million source of cash in 2018 compared to a $24 million ***use*** of cash in 2017.

Payables Continue to Rise- but Growth Is Decelerating

While MDLZ appears to be getting more aggressive in collecting its invoices, it continues to take more time to pay its suppliers. The following table shows the calculation of days payable for the last eight quarters:

	12/31/2018	9/30/2018	6/30/2018	03/31/2018
COGS	$4,224	$3,874	$3,572	$3,916
Accounts payable	$5,794	$5,374	$5,248	$5,727
COGS YOY growth	-2.1%	-2.7%	-2.7%	0.5%
Accounts payable YOY growth	1.6%	4.6%	4.7%	16.9%
Accounts payable DSPs	125.2	126.6	134.1	133.4

	12/31/2017	09/30/2017	06/30/2017	03/31/2017
COGS	$4,313	$3,981	$3,672	$3,896
Accounts payable	$5,705	$5,139	$5,012	$4,897
COGS YOY growth	3.2%	1.9%	-3.0%	-0.6%
Accounts payable YOY growth	7.3%	5.2%	9.9%	2.5%
Accounts payable DSPs	120.7	117.8	124.5	114.7

Days payable jumped in the 12/18 quarter by almost 5 days over last year's fourth quarter. However, the size of the year-over-year jumps is narrowing. With the time to pay suppliers at three months, we remain skeptical of how long the company can continue to stretch this number in a world where it takes a third as long to collect from its customers. Note that movement in payables generated $236 million in cash flow in 2018 compared to only $5 million in 2017.

Inventory Days up 2, but Finished Goods Concentration Stabilizes

We highlighted a 3-day year-over-year increase in inventory days (DSI) in our review of the 9/18 quarter which was magnified by a 120 bps increase in finished goods as a percentage of total inventory. DSIs in the 12/18 quarter jump by 2 days over the 12/17 quarter, but the finished good percentage was roughly flat with the year-ago level, reducing the level of concern.

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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