BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Conagra Brands (CAG) Investor Day Update

After studying the plans from Investor Day this week for Conagra – our skepticism has not changed. We continue to rate the stock a SELL. The basic plan really has not changed. CAG believes it can boost margins significantly and that will drive up earnings and cash flow and enable it to deleverage the balance sheet. In making these predictions, it points to its own history of growing margins and therefore integrating Pinnacle Foods should simply require applying the same plan.

Historically, CAG's record of improving margins is overstated in our view and not only will it be difficult to boost margins to the levels now forecasted, the company has barely acknowledged the operating problems with Pinnacle Foods since it was amazed a few months after closing the deal how badly it was underperforming versus forecasts. We still believe CAG overpaid for PF and issued considerable debt and shares to pay for it. If forecasts are not realized, we still expect to see write-offs related to the deal and debt remain a cloud overhanging the stock. We already highlighted last week that CAG may have seen one-time benefits from winter storms and food stamp programs that could become headwinds in the current quarter:

- **The basic plan is for 1% sales growth with margin gains of 300-400bp by fiscal 2022.** The margin gains will be driven largly by synergies from the Pinnacle Foods merger and the forecast has been increased from $215 million to $285 million. The higher margins will drive EPS and cash flow and lead to debt reduction.

- **The first of three problems on forecasts are more shares outstanding after the deal.** To post flat EPS, CAG has to grow earnings about 9% next year. **Also, it only had about half a year of PF's lower margin sales and higher interest expense in 2019, those become bigger drags on earnings next year.**

- **Backing into the operating income figure need from EPS guidance, CAG needs about 220bps of margin gain driving $250 million in improved operating income next year. Yet, synergies are supposed to build through 2020 and finish at a $156 million run-rate, meaning they probably help by $100 million next year. Where's the rest of the income coming from?**

- **The higher synergy target is suspect.** The merger has already produced several negative surprises and newly outlined plans to redo product lines, rebuild vendor relations, and fight for market share will cost money. Yet, the forecast is for more cost savings to materialize? **Also, larger forms of restructuring synergies involving capital spending were cut under the new guidance.**

- **Charts showing CAG's margins improving by 420bp from 2015-18 are overstating their prowess in cost-cutting in our view**. In 2015, CAG still had Ral-Corp, its milling operations, and Lamb Weston potatoes. If we look at just the consumer operation which is what CAG is today – the margin gain is only 40bp.

- **Eliminating lower margin divisions drove margins up and CAG has continued to cut lower margin products. Yet margins only rose 10bp from 2017 to 2018 and that was with a 65bp cut in advertising and R&D.** Pensions are have also seen a positive swing from a cost to income in recent years of 77bp.

- **Pinnacle's margins were below CAG to start and were flat for years. It has already been underperforming by over 200bp on gross margin and CAG does not expect to turn it around before late 2020. But, this is the source of the higher synergy target and margin gains coming next year.**

The New Forecast Revealed

Conagra gave its outlook this week for earnings and synergies over the next three years. All of it interplays to boost EPS and pay down the onerous debt load with higher free cash flow as well as having the EBITDA figure rise to make the debt look more manageable.

They expect synergies to rise from $215 million to $285 million by the end of 2022, about 55% by the end of fiscal 2020. Moreover, they're going to save money achieving the synergies too. The original forecast in cash costs of $355 million will now only be $320 million.

	f2019	f2020	f2022
Sales Growth	1%	1%	1-2%
Oper. Margin	15%+	n/a	18%-19%
EPS low	$2.03	$2.10	$2.70
EPS high	$2.08	$2.20	$2.80

That would put sales in the $11.3-$11.5 billion range and the debt figure will decline to 3.5-3.6x EBITDA in FY21. So, interest expense will be falling and also helping drive EPS growth higher along with margin expansion. Based on the sales range, and margins improving by basically 300-400bp – that would be about $340-$460 million in higher operating income by the end of 2022. The $285 million of synergies is expected to play a big role there.

Headwinds for the Forecast

An obvious headwind is the share count is much higher now. There used to be about 407 million shares outstanding. There are 486 million now. CAG is guiding to 446 million for fiscal 2019 and it should be at 487 for fiscal 2020 plus anything issued for stock compensation. That is some sizeable dilution. **Net income of roughly $915 million for fiscal 2019 needs to rise by over 9% to $1.0 billion to post flat EPS next year.**

Interest expense will be higher in 2020 also. The PF debt will only impact 2019 for about two quarters. In 2020 it should be $170-$180 million higher than 2019 forecasts. We'll use a 25% tax rate for both years. That means operating income in 2019 of $1.6 billion would need to rise to over $1.9 billion.

If the company is going to grow EPS in 2020, to $2.15 per share – we think margins need to improve significantly next year:

	2019	2020
EPS	$2.05	$2.15
Shares	$446.0	$487.0
Net Income	$914	$1,047
Pretax Inc.	$1,219	$1,396
Interest	$390	$560
Op. Income	$1,609	$1,956
Sales	$10,500	$11,110
Op. Margin	15.3%	17.6%

On margins, Pinnacle is starting below where CAG thought it would be. See our January 10, 2019 report on this and the last section of this report. Its gross margins are more than 200bp below forecast and sales growth is negative. Pinnacle also had a lower margin than CAG as a starting point. So, CAG already has a considerable amount of ground to make up.

Also, look at sales - 2019 only has half a year of PF and 2020 will have a full year. So a lower margin and more troubled company will be about 25%-27% of sales in 2020 instead of 15% in 2019. Also negatively impacting sales is brand building with vendor fees that are accounted for as a reduction to sales. CAG has already said that it ramped this up for PF last quarter. That could tamper sales growth.

Moreover, as shown in the next section, CAG is not seeing much volume growth on sales. We reported last week that recent sales growth was largely negative this year until Food Stamps were paid early with an extra check in the prior quarter and winter storms nationwide spurred grocery shopping. Forecasts of 1% sales growth could actually be aggressive in the case of CAG.

As it is, to reach 2020 forecasts, sales growth and the full year of PF would get Operating income to only $1.7 billion. Margin expansion must produce the other $250 million. However, CAG's guidance only calls for the synergies to be 55% achieved with a $156 million annual run-rate by the end of 2020. That means synergies will likely come in somewhere closer to $100 million next year if fully achieved as they build through the year. Where's the other $150 million coming from? Synergies are supposed to be 60%-80% of the cost savings.

The synergy goals also look suspect. We are always wary when a company announces a cost savings figure then has the merger disappoint and magically announces they found more savings to offset the disappointment. In this case, we have three reasons for skepticism.

- CAG already found unforeseen problems at PF regarding negative sales, losing market share, lack of vendor support, and margin erosion. They admit they didn't see any of this coming. Yet, a couple of months after that bomb, they announce they're more pleased than ever with the deal and see even more areas to cut and boost the cost savings by 33%. We're supposed to ignore that they also mentioned PF requires more R&D, marketing, brand support, new design, new products… Is all that free? Or does that eat into the projected cost savings?

- As CAG boosted the synergy target, it cut the amount it would need to spend to achieve it. That's another red flag for us. Operating restructuring costs will rise from $213 million to $235 million. Most of that is the cost of laying people off and relocating systems and people. However, capital spending related to the deal will fall from $142 million to $85 million. Capital spending to us normally means buying newer equipment, eliminating bottlenecks by reconfiguring production, enlarging some plants. Basically, capital spending involves larger projects that take longer and target bigger goals. CAG is cutting spending there and saying they will boost savings beyond forecasts.

- This is the same company that bought Ralcorp in 2013 and wrote off huge amounts of it almost immediately for failure to achieve merger/integration goals. It later sold it about 3 years later.

New Forecast Is Based on Conagra's Past Growth Results

Conagra points to its history of margin growth as credibility for the PF deal and cost savings:

	f2018	f2017	f2016	f2015
CAG Op. Margin	15.0%	14.9%	11.9%	10.8%

That's quite an upward move overall. Shouldn't investors take comfort in that much margin gain? We don't think so for several reasons.

- Conagra had large commercial food operation that was milling and potatoes. These were lower margin than the consumer food business. Those were spun off or put into joint ventures where the company earns equity income now. That improved margins at the full company simply having them off income statement.

- Conagra had the disastrous Ralcorp deal that was owned from January 2013 to spring of 2015. On its best days, that was a 6% margin business and was 24% of sales. That was moved to discontinued operations and sold. That also helped the margin growth shown above.

- Looking at the consumer food operation by itself, it had a 14.6% margin in 2015 even with some minor charges that were listed as impacting both the consumer and at the time still remaining commercial units which we didn't adjust for. That is basically what remains of CAG now. So, actual margin growth was about 40bp since 2015, not 420bp.

Also helping margins was the company simply let lower-performing products fade away, become a smaller percentage of sales and be discontinued in the last couple of years. All of this should have helped margins:

Grocery & Snacks in 2018 –

> "The decrease in sales volumes reflected a reduction in promotional intensity, **planned discontinuation of certain lower-performing products**, retailer inventory reductions, which were higher than anticipated, and **deliberate actions to optimize distribution on certain lower-margin products"**

Grocery & Snacks in 2017 –

> "The decrease in sales volumes was the result of reduced trade promotions and the **planned exit of certain lower-performing products."**

International in 2018 –

> "The volume decrease for fiscal 2018 was driven by strategic **decisions to eliminate lower margin products** and to reduce promotional intensity."

Foodservice in 2018 –

> "The decrease in volumes compared to the prior-year period primarily reflected the impact of exiting a non-core business, **the planned discontinuation of certain lower-performing businesses**, and softness in certain categories."

Foodservice in 2017 –

> "The decrease in volumes primarily reflected the **impact of exiting a non-core business**."

The divestitures of JM Swank, Spicetec, and Wesson Oil have also likely helped. We're not calling this a bad plan. However, we are pointing out that when looking at more apples to apples – CAG's current business was doing 14.6% margins in 2015 and after much pruning of low margin products, it did 15.0% in 2018.

That still overstates the case in our view. Plus, look at advertising and R&D spending:

	f2018	f2017	f2016
Marketing	$278.6	$328.3	$347.2
R&D	$47.3	$44.6	$59.6
% Sales	4.11%	4.76%	4.70%

In just 2018, the company picked up 65bp of margin from those two areas as a percentage of sales vs. total margin gain of 10bp.

The company states that its reported margins rising from 10.8% to 15.0% have been adjusted for pension accounting. We won't look at that as a driver of cost savings. However, there was a significant expense in 2016 taken for pensions due to a $348.5 million recognized net actuarial loss. That one-time event that most people would add back – helped set up CAG to start producing pension income into earnings rather than expense:

	f2018	f2017	f2016	f2015
Pension Cost	-$49.0	-$0.9	$413.7	$13.30

We are not certain if CAG adjusted all of this out of the mix in margins above or just the one-time item in 2016. But it's worth noting that in 2015, pensions were 15bp of expense for margins and in 2018 they were 62bp of income on margins.

Pinnacle Foods Doesn't Start with Superior Margins Either

CAG sees PF operating margins at under 15%. More importantly, we know the margins here are under pressure and CAG has already admitted this about 3 months ago. CEO Sean Connolly:

> *"On sales, we now estimate the Pinnacle portfolio will land calendar year '18 at roughly $3 billion, which is about $160 million or 5% below Pinnacle's target. Approximately $30 million of this miss is driven by our post close decisions to exit some year-end promotions that we saw as extremely low ROI. At adjusted gross margin, we now estimate Pinnacle would have closed out calendar year '18 at approximately 28%, which is roughly 230 basis points below its internal targets."*

Conagra also noted that all the major Pinnacle brands had lost market share and pricing power. It further noted that it bought Pinnacle to eliminate costs with the acquisitions and had not planned on needing to rebuild entire product lines and restore customer support. It also noted that it does not expect to see a turn-around in Pinnacle operations until late in fiscal 2020.

We were also surprised to hear CAG say it didn't see this coming. It was obvious to us via the public documents that PF had no pricing power or growth except through acquisitions:

Total PF	2017	2016	2015	2014	2013	2012	2011
Sales Growth	0.5%	17.8%	2.5%	5.2%	0.6%	0.4%	1.3%
Pricing	0.2%	0.2%	1.3%	-1.1%	0.2%	1.6%	2.0%
Volume	0.3%	0.0%	-0.7%	0.3%	-0.9%	-2.3%	-0.8%
Acquisition	0.0%	17.7%	2.3%	6.2%	1.6%	0.0%	0.0%

More importantly, we noted that PF's largest unit was Birds Eye and it after boosting margins from about 11% to 21% - sales and margins had been flat for years except during acquisitions:

Birds Eye	2017	2016	2015	2014	2013	2012	2011
Frozen Sales	$1,299.1	$1,304.8	$1,236.0	$1,115.2	$1,096.9	$1,103.1	$1,100.8
Adj. EBITDA	$278.2	288.8	$260.7	$243.5	$242.8	$228.1	$226.0
Margin	21.4%	22.1%	21.1%	21.8%	22.1%	20.7%	20.5%

We have two problems here. First, we're being told combining a flat margin business with a falling margin business is going to produce higher margins. Second, it is the area that is producing disappointment on sales, entire product lines, margins, numerous negative surprises, and needs reinvestment where CAG is claiming it will find even more synergies than it expected.

GameStop Corp EQ Update

Current EQ Rating*	Previous EQ Rating
2-	3-

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

We are lowering our earnings quality rating on GME to 2- (Weak) from 3- (Minor Concern)

We also maintain our NEUTRAL rating.

The company is talking about cutting costs and repurchasing shares, while its primary business model is seeing an accelerating collapse. We believe the revenue and product issues have become much larger in the last year. A new CEO has been hired, new board members added, and an evaluation of the business is planned. Ahead of that full transition and evaluation, GME took more impairments in 4Q after 3Q's "big bath" write-offs. It also announced a material weakness in internal controls. We believe a dividend cut is likely as part of the evaluation too.

What concerned us initially at GME was its acquisition strategy had produced a low return on capital business and were pleased to see the AT&T stores sold recently. The company had been managing its decay of selling new and used video games with hardware and producing significant cash flow to sustain an attractive dividend. There are many signs the decay is accelerating, and we fear that the company is focusing more on short term strategies.

- Pre-Owned Inventory sales are accelerating their slide. This is important because we think it drives the loyalty side of the business and encourages future sales at GME rather than a competitor. Trends in price points show trading in games may be becoming less attractive to customers and GME added a new risk factor in the 10-K – disc-less video game consoles which would eliminate physical games. The competitors' loyalty programs on the digital side are much larger too.

- Pre-Owned is 17% of sales and 35% of gross profit at GME. The trade in credit customers receive drives sales for new hardware, new games, accessories, as well as used products. Pre-Owned margins dropped to new lows and the y/y drop in gross profit of $167 million was the largest ever.

- Vendors are also competitors. As the game market becomes more focused on digital downloads – GME still relies heavily on Nintendo, Microsoft, and Sony for its inventory and vendor marketing allowances. Yet, those companies have built up their online memberships to exceed GME's and offer older games at low prices too. They have been cutting vendor allowances to GME by about $20 million per year.

- The big-bath charges were not over in 3Q18 as we anticipated. GME took another large write-down on goodwill in 4Q18 bringing the total in the year to nearly $1 billion.

- Guidance calls for more accelerating decay. Same-store sales actually rose 0.3% in 2018 despite the drop in Pre-Owned. The company is calling for -5% to -10% same-store sales growth in 2019. It is currently not planning many store closings as total sales are expected to fall by the same amount. As fixed costs deleverage on lower sales, we would expect margin erosion too. EPS was $2.70 in 2018. We think it could come in near $1.60 if sales fall 5% or even $1.04 if sales fall 10%. That doesn't bode well for a dividend of $1.52.

- Is GameStop on the right path? The company highlights that it understands the need to address falling markets for physical and used products – but that has a been a growing risk for years and there still are not many answers. Cost-cutting is being announced, but the rate of sales and margin are falling – that could swamp any efforts in cost-cutting. Efforts to sell the company failed and past efforts to diversify have failed. Buying back shares is being discussed, but that would reduce liquidity and not fix the operating problems.

- The company disclosed it found a material weakness in its internal controls over financial reporting. No financial reports have needed to be restated. The company believes the problem has been addressed but will need to test the new changes over time and hopes to resolve this fully by year end.

Pre-Owned Business is Accelerating Its Decline

One of our biggest concerns about GME was while it is still a very profitable part of the business, Pre-Owned sales are in decay. In the past, the focus generally talked about year-to-year changes based on used hardware sales becoming a larger or smaller percentage of sales as they generally sell for more dollars but carry a lower gross margin. Otherwise, GME would point to games or hardware coming late the year before and causing the trade-in market to stall the following year as a result. The first problem is the Pre-Owned unit hasn't had sales growth since 2011 and the margin essentially peaked in 2012:

Pre-Owned	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009
Sales	$1,866	$2,150	$2,254	$2,375	$2,389	$2,330	$2,431	$2,620	$2,470	$2,394
Gr. Profit	$810	$977	$1,044	$1,115	$1,146	$1,094	$1,170	$1,221	$1,140	$1,121
Margin	43.4%	45.4%	46.3%	46.9%	48.0%	47.0%	48.1%	46.6%	46.2%	46.8%

The company would see these results bounce a bit but from 2009-2015, it could forecast about $1.1 billion in gross profit coming in per year. The decay was only $30 million in 2015 and $67 million in 2017. Suddenly in 2018, it becomes $167 million decay from the previous low and margin hit a record low. The company blamed the accelerated decay on the sales of more used hardware which hurt margin. However, what should be very scary is the largest sales decline was also seen of $284 million y/y.

What GME needs to keep this business going are used physical games. Those are higher margin than hardware and people may trade in multiple games per year. Remember how this works for GME. It buys back used games and games for store credit that can be used to buy other product in the store. So, this is how they trigger sales of new games, hardware, accessories too.

In recent years, GME warned that customers migrating to digital downloading of games as a problem cutting supply the physical used game market. Not everyone trades in games also. So, the supply of games has been dropping. In the 2019 10-K, GME added a new warning:

> *"The current consoles from Sony, Nintendo, and Microsoft have facilitated download technology.* ***In addition, disc-less consoles may be available to consumers in the near term from certain manufacturers.*** *Downloading of video game content to the current generation video game systems continues to grow and take an increasing percentage of new video game sales. If consumers' preference for downloading video game content continues to increase or these consoles and other advances in technology continue to expand our customers' ability to access and download the current format of video games and incremental content for their games through these and other sources, our customers may no longer choose to purchase video games in our stores or reduce their*

purchases in favor of other forms of game delivery. As a result, our business and results of operations may be negatively impacted."

If in the near future, there are major segments of the video game market unavailable to physical game sales – that could seriously impair this part of GME's business much more. Conceivably, it could still have a Pre-Owned business centered on hardware, but that should be much smaller and lower margin. We would consider this a major risk factor.

We also question if the economics for the customer still make sense to trade in games these days. GME buys used games back at a discount with the idea of reselling it. The customer gets credit to buy a new game or a used game at a higher price. In recent years, used games sold for about 50% of the price of the average new game. If GME paid half-price for a used game, the customer could afford half of another used game of one-quarter of a new game. It appears that the value price of the used game market is falling rapidly too at this point:

Avg. Price	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009
Used Gme	$17	$25	$24	$23	$23	$21	$19	$18	$16	$18
New Game	$48	$48	$46	$44	$45	$44	$41	$39	$42	$43
Used %	35.4%	52.1%	52.2%	52.3%	51.1%	47.7%	46.3%	46.2%	38.1%	41.9%

GameStop will comment frequently about how many quarters between new game sales becoming used game trade-ins and will talk about it being slow in one quarter or stronger in another. We wonder if a customer has gone for years of getting $12 for a used game and now is only getting $8, if he simply decides to keep the older game. That trade-in decision is also impacted by higher-priced new games. It used to $12 of credit toward a $44 game. Now, its $8 credit against a $48 game. If nothing else, this may also reduce the barrier to the last hold-outs who purchase physical games an opt to go for more digital downloads.

We think this can also be seen in the drop in loyalty customers who pay GameStop. The PowerUp program grew its US business in 2018, but the paid memberships declined:

In mm's	2018	2017	2016	2015	2014	2013
Free US PowerUp	39.6	37.0	36.0	33.0	30.0	27.0
Paid US PowerUP	5.6	6.3	6.0	6.0	7.0	7.0

The paid members pay $15 per year. That has been $90 million in cash flow per year. That is now starting to decline too. We don't know the trends for y/y change for the online competitors but saw that PlayStation Network had 90 million members, Xbox Live has 59 million, and even the new Nintendo Switch Online has 8 million already.

Pre-Owned Is a Major Percentage of Earnings

As mentioned, the Pre-Owned business spurs sales of new and used equipment and games and also pulls people into the physical stores. The impact of that is tough to quantify, but we think if the Pre-Owned market continues to falter – the rest of the business units may suffer too. It will be very tough for any other part of the business to offset this decay:

$ in mm's	2018	GM%	% Total	2017	GM%	% Total
New Hardware	$150.0	8.5%	6.5%	$163.1	9.1%	6.6%
New Games	$525.6	21.5%	22.8%	$590.3	22.9%	23.8%
Pre-Owned	$810.4	43.4%	35.1%	$977.1	45.5%	39.3%
Accessories	$312.5	32.7%	13.5%	$255.0	32.5%	10.3%
Digital	$171.6	88.5%	7.4%	$162.4	85.8%	6.5%
Collectibles	$233.3	33.0%	10.1%	$208.2	32.7%	8.4%
Other	$104.7	30.5%	4.5%	$128.8	31.1%	5.2%
Total GM	$2,308.1	27.9%	100.0%	$2,484.9	29.1%	100.0%

35% of the gross profit even in a very poor year came from a unit that produced only 17% of sales. If that is driving hardware sales and new game sales – don't be fooled by the lower margins of those units. A $300-$400 hardware sale at 8.5% is producing $25-$34 in gross profit dollars. If the average new game is $48, it produces $10 in gross profit dollars vs. $7-8 on used games at a higher margin.

If GME loses more steam at Pre-Owned and has a potential game changer from manufacturers offering disc-less hardware, what is the plan to recover from that lost business impacting sales in the store of new and used products? Why should as many customers actually visit the physical stores? What differentiates GameStop as a place to download a game vs. Play Station Network? What differentiates GameStop from Best Buy or Target in selling new hardware?

The company's own digital business is growing. It was up $5 million in sales and $9 million in gross profit. But that's not even close to stemming the losses at new hardware $13 million, new games of $65 million, or pre-owned of $167 million.

Another Headwind - Its Vendors Are Also Competitors

GME sells equipment and games from Nintendo, Microsoft, Sony. Those companies also sell some of that via Amazon, Target, Best Buy, etc. too. But, more importantly, those vendor companies have their own online customer platforms and download capabilities for games. We also know that in some cases, older games are now available for download on their websites at lower prices than some used physical games offered at GameStop. We did not see that for games like Call of Duty, but less involved and older software. That seems like another area that could start to cut the values of used games and take some business from GameStop. What happens if the vendors start to emphasize older game downloads at lower prices on a wider basis?

Vendors pay GameStop allowances to help market their products in stores. These allowances are accounted as a reduction to Cost of Goods Sold by GameStop. These help boost gross margin and gross profit. We have noted this before too – the vendor payments are still falling fast:

$ in mm's	2018	2017	2016	2015	2014	2013
Vendor Allowances	$143.4	$162.5	$184.3	$208.2	$202.4	$221.0

In the last three years, GME has been losing about $20 million of gross profit per year from these declining allowances. We warned that this was a problem in our first report. $20 million of lost gross profit is a $0.15 headwind on EPS with a 24% tax rate.

This also meant that GME has had to fund more of its own advertising expense. That has been rising as a partial offset to the falling vendor allowances through 2017. However, GME cut its own advertising in 2018 also:

$ in mm's	2018	2017	2016	2015	2014	2013
Vendor Allowances	$143.4	$162.5	$184.3	$208.2	$202.4	$221.0
GS Advertising	$72.9	$83.3	$76.6	$66.6	$64.1	$57.8
Total Spend	$216.3	$245.8	$260.9	$274.8	$266.5	$278.8

Total spending on marketing almost $30 million in 2018. GME added $0.07 to EPS by reducing advertising spending to offset the cut in vendor allowances.

The Big Bath Charges Continued in 4Q18

In our 3Q18 update, we believed given the testing parameters, GameStop took a huge impairment charge to its Goodwill to help "clear the decks" of bad news prior to hiring a new CEO. It is mildly surprising, that they followed that up by writing off another huge part of Goodwill in the 4Q, including 100% of foreign Goodwill:

> *"During our annual impairment test in the fourth quarter of fiscal 2018, we determined that an additional triggering event occurred* ***upon the announcement that our Board of Directors terminated efforts to pursue a sale of the Company, which resulted in a further decline in our market capitalization, and downward revisions to our forecasted cash flows. As a result of our impairment testing in the fourth quarter of fiscal 2018, we recognized additional goodwill impairment charges of $413.4 million.*** *Goodwill impairment charges in fiscal 2018 totaled $970.7 million."*

So, the Goodwill impairment came about again in 2017 due to downward forecasts for cash flows. The total impairments on Goodwill have been marked down to $364 million from $1.75 billion three years ago before divestitures and other impairments. Also, other intangibles also had a $45 million impairment because:

> *"Store and other asset impairment charges relate to our evaluation of store property, equipment and other assets in situations where an asset's carrying value was not expected to be recovered by its future cash flows over its remaining useful life."*

Total intangibles are down to only $33.5 million.

It was interesting to hear on the conference call the company tout that it doesn't have much in the way of negative cash flow units as it wrote-off nearly $1 billion last year. According to the CFO, Robert Lloyd:

> *"During the year, we closed a net of 112 video game stores around the world, 2% of our overall video game store count. Our current average remaining lease life for our video game stores is approximately two years, which gives us tremendous flexibility to manage our footprint.*
>
> *Having said that, though 99% of our US stores were cash flow positive for the year as we're 94% of our international stores, we ended the year with 3,762 video game stores*

in the US and 1,922 internationally and with 41 domestic collectible stores and 62 international collectible stores."

Guidance Calls for Considerably More Decay

Here are the recent annual changes for Same-Store Sales:

Comps	2018	2017	2016	2015
Total SSS	0.3%	5.8%	-11.0%	4.3%
US SSS	1.8%	4.3%	-13.5%	4.8%
Intl SSS	-4.8%	9.2%	-4.4%	3.0%

Guidance from GME is calling for -5% to -10% in 2019! They are not expecting a serious decline in the store base apparently as total sales are also expected to fall by -5% to -10%.

This is a big deal in our view because it shows that hurt income in a bigger way too.

	2017	2018	-5%	-10%
Sales	$8,414.4	$8,285.3	$7,871.0	$7,456.8
Gross Margin	29.1%	27.9%	26.9%	25.9%
Op. Margin	5.4%	4.0%	3.2%	2.3%
Op. Income	$458.5	$331.1	$251.9	$171.5

Given the margin trends and the sales forecast, operating income could fall $80-$160 million as fixed costs are deleveraged and selling prices decline in the pre-owned area. The only thing that would help net earnings is GME repaid $350 million in bonds that will save it $19.25 million per year – or $16 million for the ten-months in fiscal 2019. The tax rate is forecast at 27% and the shares outstanding are 102.3 million. The EPS would come out at $1.04-$1.61 compared to $2.70 adjusted for all the impairments in 2018.

The company pointed to plans to begin a cost savings program to cut expenses by a net $100 million on an annualized basis. However, it does not expect much help on EPS in 2019. Daniel DeMatteo, the Chairman noted that the company is committed to fixing its inherent problems, but was light on details:

"One effort already under way, our profit improvement initiative is identifying ways to drive efficiencies across all areas of our business from supply chain and merchandising to optimizing our organizational structure. ***I want to emphasize that this is not simply a cost cutting exercise****, although we are looking at ways into the future to reduce costs.*

In order to drive meaningful operating profit improvement, ***we will work with a proven external consultant to evaluate all aspects of our business model****. For example,* ***we recognize the changes needed in our traditional physical video game retail business model and we are committed to addressing that****. Importantly, with new leadership and a stronger balance sheet, we are enthusiastic about the future of GameStop."*

Many of these challenges are not new although the severity has worsened of late. The decay started 8-9 years ago. There is little comfort in not hearing any specific answers on plans to fix these problems.

Is GameStop on the Right Path?

The company has tried to sell itself – that plan failed. It sold off a low ROI division of AT&T stores. That pulled in a significant amount of cash – definitely kudos there. So, while the company has problems, it certainly is not broke. It had $1.6 billion in cash at the end of the 4Q. It has since retired $350 million in bonds. Another bond issue of $475 million at 6.75% remains the only remaining debt except for operating leases. On the positive side there, a huge amount of the stores have short-term leases as noted on the conference call:

"During the year, we closed a net of 112 video game stores around the world, 2% of our overall video game store count. ***Our current average remaining lease life for our video game stores is approximately two years,*** *which gives us tremendous flexibility to manage our footprint."*

Rent expense has been falling as the company has closed stores in recent years and was $357.6 million last year. Of the remaining $947 million of contracted leases, as the company noted over half can be rolled over (potentially at lower rents) or closed in 2019 and 2020:

	2019	2020	2021	2022	2023	After
% of Lease Expiration	31%	22%	16%	11%	8%	12%

The real estate footprint can be significantly modified without huge cash costs associated with breaking leases.

The bigger questions are "What is GameStop going to do?" and "What product is GameStop going to sell?" Talking about cost-cutting is fine, but the revenue decay may be a larger problem that may more than swamp cost-cutting. Their plan is to improve the cost structure by $100 million with little of that seen during 2019. They just saw operating earnings adjusted for impairments fall by $127 million last year and that included cutting advertising to offset that amount. Guidance on sales points to operating income falling $80-$160 million in 2019.

New board members want the company to buy back $700 million of stock to improve shareholder value. The company announced a new $300 million stock plan. Can anyone else say Sears or Eastman Kodak? Buying back shares while the company's business is facing pressure and technology-related obsolescence is unlikely to push up the value of shares in our view. Every year the sales and earnings get lower the market is likely to grow more dire on the future prospects. Rather than spend the cash to help all shareholders – the company will have spent cash to pay some shareholders to leave. The remaining company loses liquidity and continues to experience rising operating problems – hardly a recipe for a turnaround story.

The company's acquisition history is not stellar either. As we wrote in our first report on GameStop, its diversification into Apple related stores and wireless phone stores resulted in a number of impairment charges and poor returns on investment.

The company has the cash to pay the dividend too, but why maintain it at this level? It's over a 15% yield and consumes $157 million annually in after-tax cash flow. That seems a likely target for reduction this year especially with a new leader coming onboard in April. Already the market expects this – if the dividend was holding up the stock price still, the yield may be 8%, but it wouldn't be 15%. Cutting it to repay the 6.75% bonds may make some sense in a goal to become debt free in a few years. If nothing else, it preserves liquidity. The business also remains seasonal with a poor 2Q historically and a 3Q that often requires some higher inventory investment.

There is flexibility and liquidity here. We think the debate should be on whether to have a turnaround plan – and there are almost no details for one of those – or have an orderly liquidation over time that retires all debt, takes advantage that stores are still cash flow positive and can be downsized without burning cash. There are assets here to sell such as the collectibles unit, perhaps even the loyalty program and digital sales division. There is enough cash to retire all the debt and the company would still be cash flow positive as it shrinks the store base and sees rent expense and wages decline.

Weak Internal Controls Is Another Issue Here

After 4Q results, GameStop also announced it discovered a material weakness in its internal control over financial reporting. No past financial statements have been restated at this point, and no mistakes have been identified. The company does have a remediation plan in place and expects to tie up this issue before year-end. It may already be fixed, but to be considered complete, the new controls must operate for a period of time to test them.

Zimmer Biomet (ZBH) EQ Update- 12/18 Quarter

Current EQ Rating*	Previous EQ Rating
4+	3-

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

We are upgrading our earnings quality rating of ZBH to 4+ (Acceptable) from 3- (Minor Concern).

- Our primary concern with the quality of the previous quarter was the lower-than-expected tax rate without which the company would have missed earnings targets. In the 12/18 quarter, the effective tax rate was in-line with expectations.

- The outstanding principal amount of receivables sold increased to $365.9 million versus $261.2 million at the end of 2017. Still, after adjustment for the receivables sales, days sales outstanding still declined by approximately 7 days from a year-ago. The face value of receivables sold off during 2018 was $2.7 billion, up from $1.5 billion in 2017. Still, the company estimated that incremental cash flow from its receivables securitization programs was only $33 million for the year ended 2018, down from $174 million last year. Given the approximate $105 million increase in sold receivables outstanding we are not sure how there was only a $33 million incremental increase to cash flow. According to the cash flow statement, the decline in receivables balances added $213.6 million to operating cash flow in 2018 versus $161.7 million in 2017. Clearly, increased collections and sales of receivables have combined to provide a meaningful boost to cash flow growth which will likely begin to fade in 2019.

- Accounts payable days at the end of the 12/18 quarter rose by more than six days compared to the year-ago quarter. This is the first large jump in recent experience and coincides with an increase in inventories as the company increases in-stock levels and prepares for new product rollouts.

- The company has provided modest guidance for 2019 of essentially flat sales growth with flat-to-down operating margin growth which reflects increased investments. The mid-point of the expected operating cash flow forecast represents a decline of about $90 million and includes an anticipated $170 million litigation payment. Cash flow growth should be boosted some by a decline in integration and quality remediation payments. We consider the cash flow forecasts to be more than reasonable even if the receivables tailwind weakens.

- ZBH took an additional $975.9 million write-off to goodwill in the 12/18 quarter. About $567 million related to the EMEA reporting unit, leaving $755.2 million related to that division on the books. Another $401.2 million was related to the Spine reporting unit which totally wrote off the balance of that segment's goodwill which was a result of the 2015 Biomet and 2016 LDR acquisitions. The company also warned in the 10-K that fair value of the $387 million of goodwill associated with its Dental unit was only 5% above its carrying value meaning more impairments could be on the way.

Eaton (ETN) EQ Update -12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	3+

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

We are maintaining our earnings quality rating of ETN at 3+ (Minor Concern)

- Warranty expense fell by 20 bps as a percentage of sales in 2018 as 2017 experienced both higher warranty claims and expense. As of the end of the year, the warranty reserve was about 10 bps lower as a percentage of sales. Overall, the company does not appear to be grossly under-reserved and the provision expense is moving in-line with warranty settlements. Still, 2018 enjoyed an easy comparison that provided what we view as a non-operational boost to operating margins on the order of 16 bps (6 cps) which is not likely to repeat in 2019.

- The increase in inventory has moderated as the year-over-year rise in DSIs fell to under 2 days in the 12/18 quarter. Note that this is the first year-over-year comparison that does not require an adjustment for the company's change to FIFO (first-in, first-out) inventory accounting in the 12/17 quarter. We have not been overly concerned by the inventory increase as the company's explanation of pre-buying ahead of tariffs was plausible. The moderation in growth now makes this a non-issue in our view.

- The company enjoyed two quarters of declining R&D expense which has now flattened. The company projects pressure on margins in 2019 as it is investing in its eMobility segment.

While the R&D benefit is over and the inventory build has abated, the warranty expense increase prompts us to keep our earnings quality rating at 3+ (Minor Concern)

Warranty Expense Declined

ETN only discloses its warranty reserve detail on an annual basis. The 10-K contained the following data on the progression of the account:

	12/31/21018	12/31/2017	12/31/2016
Beginning Warranty Allowance	$188	$180	$195
Provision Expense	$139	$163	$117
Amounts Settled	-$145	-$156	-$130
Other	-$6	$1	-$2
Ending Warranty Allowance	$176	$188	$180
Allowance % of Sales	0.81%	0.92%	0.91%
Provision Expense % of Sales	0.64%	0.80%	0.59%

Provision expense jumped in 2017 to 0.8% of trailing sales as warranty claims increased. However, claims decreased in 2018 and provision expense fell by 16 bps. The ending allowance was about 10 bps lower as a percentage of trailing sales at the end of 2018. Overall, the company does not appear to be grossly under-reserved and the provision expense is moving in-line with warranty settlements. Still, 2018 enjoyed an easy comparison that provided what we view as a non-operational boost to operating margins on the order of 16 bps (over 6 cps) which is not likely to repeat in 2019. Given the disclosure is on an annual basis, it is impossible to tell if the benefit of lower warranty expense disproportionally benefitted a particular quarter during the year.

Danaher (DHR) EQ Update- 12/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	4-

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

We are maintaining our earnings quality rating of DHR at 4- (Acceptable).

- Our review of the 12/18 quarter turned up no significant items of concern. We do note that the acquisition and divestures over the years do not make for clear insight into certain earnings quality trends.

- We look for more color in the first quarter on the announced acquisition of GE's Life Sciences business. The company is paying $21.4 billion, or 17 times the expected 2019 EBITDA for the division. The company recently issued 12.1 million common shares at $123 and 1.65 million shares of 4.75% mandatory convertible preferred shares to provide a little over $3 billion of the purchase price. The deal is expected to reduce GAAP diluted EPS by $1.15-$1.20 but projects accretion of adjusted EPS of $0.45-$0.50 in the first full year of operation. The deal will not be completed until 4Q19.

- DHR still expects to complete the spin-off of its Dental Unit in the second half of 2019. The company has not begun disclosure as a discontinued operation yet, so details are scarce. It did comment in the recent call that it plans to lever the spin-off at about two times with a goal of an investment grade rating.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

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