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Air New Zealand (AIR.NZ, ANZFF) – BUY

We are initiating Air New Zealand (AIR.NZ, ANZFF) with a BUY recommendation. This is based on four basic points. There is underlying inherent growth as more people travel to New Zealand – the forecast is demand will more than double over 25 years and an incredibly small part of the US, China, SE Asian market has been tapped at all at this point.

The company has seen three negatives impact operations in the form of manufacturer problems with engines, higher oil prices, and capacity increasing on domestic routes faster than passenger growth. In all cases, these headwinds have masked some cost-cutting and greater operating efficiencies. These issues could all become neutral factors or tailwinds shortly and help EPS growth.

Heavy capital investment in boosting and modernizing the fleet is largely ending this fiscal year in June. That should improve cash flow and the balance sheet further. On top of that, the stock is cheap in our view: It is trading for 11-12x what should be an impaired fiscal 2019 EPS, roughly 5.3-5.5x EBITDA + rent. The dividend is 8% and given the forecasts for capital spending in future years, should only consume about one-third of free cash flow.

Liquidity remains strong with over \$1.2 billion in cash versus \$2.8 billion in debt and a market cap of about \$3 billion.

We expect the lessening of short-term negatives to fuel EPS along with the macro tailwind of 4%-7% growth in travelers and the company's efforts to hold the line on costs with modernization and recent capital investments. Removing the engine cost issues and having oil stabilize or fall marginally could lower the P/E to under 9x.

- **Macro Tailwind – Air travel to New Zealand is strong. Auckland Airport is showing more airlines are coming, more routes, and growth in air travel is running over 4%. Forecasts have air travel rising 23% by 2024 and more than doubling by 2044.** Many huge population centers like China, USA, and India are still very minor parts of New Zealand tourism.
- **Macro Tailwind – Heavy infrastructure spending has been done to encourage and support more growth.** Auckland Airport is 6-years into a heavy modernization and expansion plan with new terminals, gates, more retail, hotels, and streamlining passenger customs procedures. Air New Zealand is doing the same with its fleet and is near the end of the heaviest spending.
- **Macro Tailwind – Air New Zealand is the dominant player for domestic traffic and will pick up intra-country passenger travel no matter what airline delivers tourists to New Zealand as the first leg. Also, Air NZ has revenue sharing and code sharing deals with many major carriers in China, Singapore, the US, and Australia.**
- **Catalyst that Could Improve – Air NZ's Boeing 787s have had problems with Rolls Royce engine blades wearing out sooner than expected. Rolls Royce is fixing this, but its parts and staff are in short supply so many of these planes have been grounded for parts of 2018 and 2019. This disrupted the company's flight schedules, led to replacing them with other planes that burn more fuel, and resulted in the company keeping extra staff to deal with passengers. This problem is expected to be resolved fully by September.**
- **Catalyst that Could Improve – capacity additions on domestic routes exceeded passenger growth in recent months.** This is impacted by International travelers not arriving with the engine issue. It is focused in lower-end leisure travelers as well and is **already showing signs of bouncing back as Air NZ cut leisure fares and postponed some new plane deliveries to let demand catch up with capacity growth.** Given the

fixed cost nature of an airline, adding incremental passengers even at low fares largely falls to the bottom line.

- **Catalyst that Could Improve – the hefty capital spending should end in fiscal 2019 (this June).** Screens and casual observers see an 8% dividend with weak cash flow due to high capital spending and weakness in earnings from the issues above. **As the capital spending declines as planned, the dividend coverage should improve to about one-third of free cash flow.**
- **Catalyst that Could Improve – Oil prices rallying in the last two years have boosted fuel costs at Air NZ.** The company hedges this to remove the spikes, but a prolonged upward move hurts margins. **Oil can add or subtract 15% of EPS in any given year. Given the two-year move, there may be less upside pressure than down or neutral at this point.** This is an issue Air NZ does not control and will always be an inherent risk.
- **Air NZ has steadily improved its cost structure.** Carrying more passengers on one plane instead of two, newer planes needing less maintenance, longer flights that spread ground costs over more kilometers all create operating efficiencies. **The company has seen labor costs per kilometer steadily fall along with maintenance, and sales costs. New plane costs are leveraging too.** The company generally looks to cut about \$50 million of costs per year and some of that was offset by issues described above in 2019 too.
- **Accounting and Reporting look conservative.** It depreciates planes and engines over shorter periods than we see from other airlines which lowers EPS. It capitalizes all its leases as debt. When it calculates debt ratios it uses 7x forward rent to capitalize operating leases. However, that resulting figure is larger than all the future operating lease obligations, so they actually overstate their debt ratios a bit. The company has not been issuing shares to dilute investors. It actively explains, updates, and shows sensitivity analysis on FX and oil prices.

Macro Story – Part One – Air Travel to New Zealand Is Strong:

New Zealand has about 4 million residents. However, it has more than that figure every year in both international travelers and domestic travelers at Auckland Airport:

| mm's passengers | Intl. | Dom. |
|-----------------|-------|------|
| 2019 half | 5.29 | 4.82 |
| 2018 | 10.20 | 9.26 |
| 2017 | 9.74 | 8.60 |
| 2016 | 8.78 | 7.90 |
| 2015 | 8.12 | 7.20 |
| 2014 | 7.69 | 6.91 |
| 2019 growth | 4.4% | 4.0% |
| 2018 growth | 4.7% | 7.7% |
| 2017 growth | 11.0% | 8.9% |
| 2016 growth | 8.1% | 9.8% |
| 2015 growth | 5.7% | 4.2% |
| 2014 growth | 5.1% | 2.2% |

The growth rate can bump up in years when larger amounts of air capacity is added. While some markets can show negative growth, the overall growth rate has remained solid. Also, the law of large numbers is also evident. When 2018’s international growth was 4.7% it looks weaker than 2015’s 5.7%. However, it’s off a larger base. For example, 2018 showed a 459,250 increase against 2015’s 436,600.

Auckland Airport expects to have 24 million travelers in 2025, which is up 23% from 2018’s 19.5 million. That compares with the 38% growth already seen since 2014 to 2018. The airport data shows the 51-year CAGR has been almost 8% for International and 5.7% for Domestic (obviously starting from a low base.) The long-term forecast is 44 million travelers by 2044.

This forecast is based on greater growth coming from some big markets that had very little direct travel options in past years:

| 000's passengers | China | USA | India | Japan | Germany |
|------------------|--------|--------|-------|-------|---------|
| 2018 | 395.08 | 272.17 | 61.32 | 94.30 | 76.07 |
| 2013 | 213.78 | 151.59 | 30.22 | 63.56 | 49.94 |
| Growth | 85% | 80% | 103% | 48% | 52% |

New Zealand, with about 4 million residents, is 2.3 million or 45% of the international travelers out of Auckland. Australia, with about 25 million residents, is about 860,000 of the international travelers, or 17%. The view is that the penetration rate in much larger countries is untapped. For example, 0.5% of the US population is 1.65 million, 0.1% of China or India is 1.4 million people. Those are both several multiples of the current level of visitors. None of these countries are even 8% of total international visitors now.

Macro Story – Part Two – Heavy Infrastructure Building for New Zealand Travel

Starting in 2013, Auckland Airport launched a heavy capital spending plan to focus on growth. This included rebuilding and modernizing the International terminal, adding gates, boosting retail and duty-free shopping significantly, adding customs streamlining to make it faster for travelers, new restaurants and hotels, and upgraded airport clubs. This is being followed by better parking, greater road access, a new domestic terminal by 2022, and a second runway by 2028.

Capital spending at the airport has risen rapidly of late:

| \$NZ | 2018 | 2017 | 2016 | 2015 | 2014 | 2013 |
|------|-------|-------|-------|-------|-------|------|
| CapX | \$406 | \$358 | \$234 | \$145 | \$119 | \$90 |

Auckland Airport is planning to spend \$450-\$550 million in 2019 and \$2 billion by 2022. The company has further invested in lowering fees to airlines to attract business and seen several airlines commit to more service at Auckland. At the same time, the New Zealand tourism bureau has set up many offices in foreign cities as new routes are introduced to help bring in new visitors. It has added 12 new airlines and 21 foreign routes since 2015 that fly to Auckland.

Air New Zealand is showing the same high capital spending:

| \$NZ | 2018 | 2017 | 2016 | 2015 | 2014 | 2013 |
|------|-------|-------|-------|---------|-------|-------|
| CapX | \$809 | \$853 | \$998 | \$1,118 | \$644 | \$382 |

The forecast is that after 2019, the spending level will decrease for a few years at Air New Zealand:

| \$NZ | 2022 | 2021 | 2020 | 2019 |
|---------------|-------|-------|-------|-------|
| Forecast CapX | \$210 | \$100 | \$410 | \$790 |

When this fleet investing is complete, Air NZ will go from 104 planes to 115. More importantly, it will have retired 49 older planes that are often smaller than what they will be replaced with such as 787s with 302 seats replacing 767x with 230 seats and ATR72-600s with 68 seats replacing Beech 1900D's with 19 seats. So, there will be 60 new planes with higher seating. The long-haul planes will grow from 20 to 29, plus 18 New A-320/321 NEOs will have extended range for medium range routes within the Pacific.

Air New Zealand is actually building even more capacity by joining more international airlines in code sharing and revenue sharing arrangements. In code sharing, customers earn frequent flier miles on another airline. Basically, a member of United Airlines loyalty program can fly Air New Zealand and earn miles on United or the reverse with an Air New Zealand loyalty member earning points by flying United. It allows customers to book more detailed trips and stay in the same alliance such as Austin, Texas to Queenstown, NZ on one reservation.

In revenue sharing, the alliance airlines split the total fare based on the miles it flies of the total trip of the passenger. Let's say the passenger pays \$2,000 and flies 9,000 kms. If 6,000 kms are on Air New Zealand – it earns $\$1,333 (6,000/9,000) * \2000 . However, the bigger edge comes on aircraft investment. A route may only support one flight a day at certain times per year and at other times two. Each airline may be able to allocate one plane 3x per week at times and one plane 7x a week at other times. In the non-peak season, each can move a plane to a busier route rather than maintain the service at a lower load factor.

As more airlines have started flying internationally to New Zealand, Air New Zealand has added more partners. In 2014, it had revenue sharing deals with Virgin Australia and Cathay Pacific. In 2018, it now has revenue sharing with Cathay Pacific and added Air China, Singapore Airlines, and United. It now has code sharing with Qantas, Air Canada, ANA, and Aerolineas Argentinas.

The other part to consider is Air New Zealand is the dominant player for people flying within New Zealand. So once an international passenger arrives, even on a non-alliance carrier,

he is likely to travel on Air New Zealand if he goes to Christchurch or Wellington from Auckland. Auckland Airport reported 9.26 million domestic passengers in 2018. Air New Zealand serving all airports in the country reported 11 million domestic passengers in 2018.

The Timing Also Looks Interesting to Us

We have followed this company from afar without taking action for a couple of years and believe there are several catalysts that could also help investors. All appear to have been areas that hurt the stock price and sentiment but should mitigate very soon:

The Rolls Royce Trent Engine on the Boeing 787 is the first problem. Air NZ has 13 of these planes with 1 more on order. It also had two incidents involving the turbine blades on these engines wearing out faster than expected by Rolls Royce. The net impact was these planes were grounded for a time. That pulled capacity off some of its long-haul routes. The problem can be fixed, it's a matter of speeding up the check/repair/maintenance cycle.

However, Rolls Royce lacked the parts and staff to handle the accelerated schedule for maintenance. Thus, of the 13 planes at Air NZ, there have been times when it has not had access to as many as five of them while awaiting maintenance. In late February it was two planes, and Air NZ expects by September to have this fully resolved and all planes back in use.

As this incident happened, it disrupted the Air NZ schedule and passengers had to be accommodated. The company had to add extra staff for that. It leased some additional Boeing 777 planes as replacement planes when possible to return capacity. Rolls Royce will largely pay for that – but those planes use more fuel, they can require additional employees, and the company may have lost some travelers flying both the international route and the domestic routes. The company can only quantify about \$30-\$40 million in costs for fuel and staff. At the time this began, Air NZ was earning about 34-35 cents per year and \$30-\$40 million would be 2-3 cents per share. We think there would be also been some lost business and bad publicity that hit as well. If this problem is completely resolved in five months, it should lift a bit of a cloud on earnings and operations.

The second recent change involved capacity additions exceeding passenger growth on domestic routes and routes across the Tasman Sea and Pacific Islands. The table below shows this on a year over year basis for each month from the last year. The first three

columns show the total passenger count change y/y. The last three columns show the change in load factors. Load factor represents the ratio of kilometers/seat flown by a passenger divided by kilometers/seat available. The ratio declines when passenger count falls or capacity grows faster than passengers. It rises when passenger counts increase, or passengers grow faster than capacity:

| YY Chg | Total Pass | Dom Pass | Tas Pass | Chg Total Load | Chg Dom Load | Chg Tas. Load |
|--------|------------|----------|----------|----------------|--------------|---------------|
| 19-Feb | 5.8% | 4.7% | 10.7% | 0.5 | -0.9 | 1.0 |
| 19-Jan | 4.1% | 1.5% | 8.9% | 1.7 | -0.4 | 0.2 |
| 18-Dec | 4.5% | 3.2% | 6.9% | 0.1 | -0.7 | 0.0 |
| 18-Nov | 4.2% | 3.3% | 8.9% | -0.7 | 0.3 | -0.1 |
| 18-Oct | 4.4% | 3.4% | 7.5% | 0.6 | 1.1 | 0.6 |
| 18-Sep | 6.0% | 6.2% | 7.5% | 1.5 | 3.9 | 0.6 |
| 18-Aug | 5.3% | 4.3% | 8.5% | 2.7 | 2.3 | 0.6 |
| 18-Jul | 4.7% | 3.4% | 7.0% | 0.8 | -0.7 | -0.1 |
| 18-Jun | 5.2% | 4.0% | 8.3% | 0.4 | 2.1 | -4.8 |
| 18-May | 6.3% | 5.6% | 8.7% | 0.3 | 1.9 | -1.2 |
| 18-Apr | 7.8% | 7.7% | 9.2% | -0.8 | 4.1 | 1.0 |
| 18-Mar | 8.6% | 7.9% | 9.6% | 3.5 | 2.4 | 2.1 |
| 18-Feb | 5.3% | 4.4% | 8.3% | 1.5 | 2.6 | 2.5 |

Looking at the recent trends, it is evident that passenger growth continues to remain strong overall as the macro-story points to. In the case of domestic passenger growth, it definitely started running slower than expected with months in the 3's and a 1.5% growth figure in January 2019. The Tasman and Pacific routes have continued to show very strong growth, but there has been more capacity added that has kept the load factors largely flat. This is a case of passengers growing at a linear rate, while capacity grows like a stair-step. We are not concerned when we see the actual passenger growth remaining strong, so the Tasman statistics make sense.

Air NZ lowered guidance with the domestic traffic growth falling from 5%-7% to 3% which hurt the stock. On the last conference call, management indicated that they saw weakness at the low-end leisure traveler. Premium seats and business travel continue to be strong. As the forward bookings in December started to look weak, the company responded. It pushed out deliveries of some planes to slow capacity growth for domestic planes to about 4% growth from the previous 4%-6%. All the planes will still come online, but three will arrive about 6-12 months later, one will arrive 2 years later and two will arrive 5 years later, which spreads about \$750 million of capital spending over more years. They lowered the

bargain fares more and simplified the fare structure to stimulate traffic. In addition, they boosted marketing in some long-haul markets to stimulate more International traffic that feeds into the domestic market. (American Airlines going to a seasonal schedule for New Zealand may have also played a role in lower domestic market ticket sales for Air NZ.) The company said they have seen stabilization of the forward six-month domestic growth after January at about a 4% rate. It would appear that some of this should also be short-lived.

Given the nature of airlines operating model of very high fixed costs and almost no variable costs – we do not believe some of the fare discounting will hurt earnings. It may even help them. Essentially, a flight takes off with pilots, staff, pays landing fees, has fuel and maintenance – all those costs are largely the same with 80 people or 100 people on board. Adding an incremental 20 people at a lower fee is still flowing largely to the bottom line.

In our view, the growth rate still looks to be intact and Air NZ still has the dominant market share. While there may be future bumpiness to load factors and passenger growth during short periods, we think the negative news offers a good chance to buy.

The third catalyst we see is that Air NZ is going to see capital spending decline after this fiscal year (which ends June 30.) We referred to this above in the macro section on infrastructure spending. This is a company that has been spending \$800 million to \$1 billion dollars per year on new equipment. That figure will drop to about \$100-\$400 million for the next several years. By itself, that should drive up free cash flow. We believe that the steady passenger growth, the new planes, the end of the Rolls Royce issues will also help earnings and drive up free cash flow in that manner too. While this should be obvious, we were surprised the company received questions on the last call on whether they can support the dividend.

The dividend is essentially \$260 million per year. Cash from operations runs about \$1.0-\$1.1 billion in most years. The capital spending has been elevated, which Air NZ is paying for with cash on hand, selling equity investments it has held, and leasing some of the new planes. But the capital spending figure is about to fall to \$100-\$400 million for several years. Plus, new planes and getting the engine issues behind them should boost income and the normal \$1.0-\$1.1 billion figure for cash flow. The dividend payout is likely to be under 35% of free cash flow after FY 2019. Guidance with the negative issues this year is for pretax income of about \$370 million, which should translate to about \$900 million in cash from operations for the last year of heavy capital spending. The liquidity is here with cash at \$1.2 billion and the company is committed to the dividend:

“Financial resilience is always going to be our key number one priority when start considering distributions. But we look that (debt ratios). We look at how we’re resolved on improving earnings growth. We’re very comfortable with where the dividend sits. And as you know, there’s a significant period of CapEx reduction coming up, so we’re very confident about where that’s sitting.”

Looking at it from the perspective of earnings, fiscal 2019 definitely has some noise. But the dividend of 22-cents should be below EPS of 26-cents. Normally EPS is 38-40-cents +/- fuel changes so the earnings payout looks sustainable given the potential EPS growth the new capacity should provide for several years.

Air New Zealand Has a Good History of Leveraging and Cutting Costs

Airlines have several levels of operating costs. They often report them on a per mile or per kilometer metric. Air NZ has seen costs per kilometer decline from 2014 to 2018 from 10.9 cents to 9.5 cents. That doesn’t fully reflect what is happening:

| | 2018 | 2017 | 2016 | 2015 | 2014 |
|-------------------|------------|------------|------------|------------|------------|
| Labor | 2.9 | 3.0 | 3.1 | 3.4 | 3.4 |
| Maintenance | 0.8 | 0.8 | 0.9 | 0.9 | 0.9 |
| Aircraft Ops. | 1.4 | 1.3 | 1.3 | 1.3 | 1.3 |
| Passenger Service | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 |
| Sales & Marketing | <u>0.8</u> | <u>0.8</u> | <u>0.9</u> | <u>0.9</u> | <u>0.8</u> |
| Total | 6.6 | 6.5 | 6.8 | 7.0 | 7.0 |
| Depreciation | 1.2 | 1.2 | 1.2 | 1.1 | 1.3 |
| Rent/Lease | 0.5 | 0.5 | 0.6 | 0.6 | 0.5 |
| Fuel | 2.2 | 2.0 | 2.1 | 3.1 | 3.4 |
| FX | 0.0 | 0.0 | -0.3 | -0.2 | -0.1 |
| Other | 0.6 | 0.6 | 1.0 | 0.7 | 0.7 |
| ASK | 44,274 | 42,169 | 39,684 | 35,601 | 33,396 |

Capacity is up 33% over that timeframe which is a combination of more long-haul flights adding kilometers and more planes adding seats. ASK is Available Seat Kilometers to sell. The top five expense categories also include depreciation and rent/lease expense. But we also pulled those out to see them separately.

We are pleased to see the labor costs being leveraged and the company expects to be able to recover more there as the engine issues abate. The same with passenger service. The newer planes burn less fuel, should need less maintenance, and have not raised the capital-related costs of rent, leases, and depreciation. So that is a net win for the company too. Other expenses have been very stable but for a large one-time item in 2016.

The company is committed to finding \$50 million of cost savings per year and talks highly of their record in that area. New training and systems roll-outs focus on that area. If they can save \$50 million per year, that is a 0.1 cent per ASK tailwind on costs. In 2019, they aren't fully realizing it as they have \$30-\$40 million of headwinds from the engine issue. So, in future years, there could be a catch-up in that area. It seems likely ASK will also continue to rise and leverage costs more.

It is also worth pointing out that short flights have higher costs per kilometer. The take-off, landing, gate, ground fees, airplane servicing costs are spread over fewer kilometers of flying. Longer flights tend to lower cost per ASK. Doing more International should help these cost numbers too.

Fuel Is the Wildcard but Has Moved Up Already

From the table above, it appears that the only real wildcard here is fuel prices. Newer planes help, but the price per gallon is still the top issue in the short run. It appears that the underlying costs are about 7.1-7.3 cents per ASK before fuel. Then fuel runs between 2.0-3.3 cents per ASK. That seems to be holding true even in fiscal 2019. Despite some capacity not being fully absorbed and the extra personnel and engine issues the cost per ASK rose from 9.2 cents to 10.0 cents. Of that amount, 0.6 cents was due to rising fuel prices.

Air NZ gives sensitivity guidance on fuel prices net of hedging costs. At \$75/barrel they are paying about 2.6 cents for fuel. +\$10/barrel would make it 2.75 cents while -\$10/barrel would make it 2.50 cents.

If 2017's fuel costs had been 2.5 cents per ASK, EPS would have dropped from 34-cents to 21-cents and 2018 would have seen EPS fall from 34-cents to 26-cents. It is likely the hedging could have cut some of that impact, but the other reason we think the stock has

some merit is oil prices have already risen considerably in the last two years. We're not going to predict oil prices beyond saying we're not in the camp predicting \$100 oil is near and do not expect \$30 either.

The company hedges fuel costs and FX, but we believe that covers the short term events and takes out the highs and lows. It would be difficult to hedge against a prolonged move up or down in fuel or currency. They have an inherent issue with FX because they buy fuel in US Dollars and get paid in NZ Dollars as well as other currencies. We don't have a problem with the hedging, and FX has been fairly immaterial to the company in recent times on an ASK basis.

Our conclusion is the company has successfully reduced per unit operating costs by about 0.4-0.5 cents and has a plan to continue cutting another 0.1 cents per year in the near future. Against that, fuel is a wild card can easily move \$100-\$200 million in any year which is 0.2-0.4 cents per ASK of headwind or tailwind and 7-14 cents in EPS. Fuel will always be a risk in owning an airline, we believe it is more likely to be neutral to positive in the near future than a headwind when oil was \$30.

Accounting and Reporting Look Conservative to Us

For a company going through a sizeable replacement and growth phase of its PP&E, we believe Air NZ is actually very conservative.

It is deprecating planes over 18 years and engines over 15 years. We pulled up Southwest Airlines simply because it hasn't been to bankruptcy or through several large mergers. Southwest depreciates all flight equipment over 25 years. Air NZ's income may be overly penalized from this higher depreciation. That doesn't impact cash flow, but it certainly lowers EPS and makes the Dividend/EPS ratio look tighter.

Air New Zealand capitalizes all its leases, both financing and operating, as debt. That is the standard coming under IFRS-16 to have a single model for both types of leases. Air NZ capitalizes operating leases at 7x rent expense. That is conservative again because the total obligations under operating leases is less than what they are reporting as debt:

| Total Future Obligations | 2018 | 2017 | % Due less 5-years |
|--------------------------|-------|-------|--------------------|
| Aircraft Op. Leases | \$907 | \$785 | 75.0% |

At the end of fiscal 2018, Air NZ only had \$907 million in total lease obligations. Moreover, 75% of the aircraft leases were due in less than 5 years.

However, in calculating debt ratios – Air NZ adds back rent expense to EBITDA and then capitalizes the operating lease debt at 7x the next 12 month's rent:

| Rent Expense | 2018 | 2017 |
|---------------------|---------|---------|
| Aircraft Op. Leases | \$176 | \$160 |
| Debt x7 | \$1,232 | \$1,120 |

They are adding roughly \$300 million more to the net debt calculation.

| Net Debt Calc | 2018 | 2017 |
|---------------|----------------|----------------|
| Secured Debt | \$1,563 | \$1,243 |
| Unsec Debt | \$50 | \$50 |
| Fin Lease | \$1,121 | \$1,221 |
| Less Cash | -\$1,567 | -\$1,501 |
| 7x Op. Lease | <u>\$1,232</u> | <u>\$1,120</u> |
| Total | \$2,399 | \$2,133 |

That's a 13% increase and that effectively boosts leverage ratios of Net Debt/(Net Debt + Equity) and Debt to EBITDA + rent calculations.

The company is not issuing shares which have held steady for several years and it has good disclosure on its hedges for fuel including sensitivity analysis. This also includes FX where about 60% of revenue is in NZ Dollars with 14% of revenue in US Dollars along with fuel.

Snap-On (SNA) Update- 3/19 Quarter

Maintain SELL

- SNA's contract receivable days rose by 3.3 over the year-ago quarter with all of the increase centered in long-term receivables. While the year-over-year pace of expansion has slowed, it appears that the company is continuing to increase credit extension to franchisees to boost sales to that channel.
- Past-due receivables stats for contract receivables improved in the quarter and led to a \$3.3 million decline in provision expense for the portfolio which we estimate provided a 4.5 cps tailwind to EPS.
- The increase in extension of credit to customers via finance receivables continued with total long-term contract receivables days of sales jumping by almost 8 days of total non-financial revenue. Total delinquencies as a percentage of gross finance receivables fell by 8 bps with all categories improving except for a slight uptick in receivables delinquent by 35-59 days.
- Inventory days of sales (DSI) increased by almost 10 days over the year-ago quarter, continuing a long trend of inventory growth outrunning sales growth.

Contract Receivables

SNA's contract receivables include amounts due from external customers, but also loans to franchisees to fund working capital, franchise and van leases, and the expansion of existing franchises. The below table shows the calculation of short and long-term contracts days of tool group sales:

| | 3/30/2019 | 12/29/2018 | 9/29/2018 | 6/30/2018 |
|---------------------------------|-----------|------------|-----------|-----------|
| Snap-on Tools Groups Sales | \$410.2 | \$407.4 | \$389.8 | \$411.9 |
| ST Contract Receivables | \$92.9 | \$98.3 | \$105.6 | \$87.6 |
| ST Contract Days | 20.7 | 22.0 | 24.7 | 19.4 |
| LT Contract Receivables | \$345.1 | \$344.9 | \$338.1 | \$332.6 |
| LT Contract Days | 76.8 | 77.3 | 79.1 | 73.7 |
| Total Contract Receivables | \$438.0 | \$443.2 | \$443.7 | \$420.2 |
| Total Contract Receivables Days | 97.4 | 99.3 | 103.9 | 93.1 |
| | | | | |
| | 3/31/2018 | 12/30/2017 | 9/30/2017 | 7/01/2017 |
| Snap-on Tools Groups Sales | \$404.7 | \$409.2 | \$392.7 | \$413.8 |
| ST Contract Receivables | \$92.0 | \$96.8 | \$99.8 | \$82.4 |
| ST Contract Days | 20.7 | 21.6 | 23.2 | 18.2 |
| LT Contract Receivables | \$326.1 | \$322.6 | \$310.4 | \$299.4 |
| LT Contract Days | 73.5 | 71.9 | 72.1 | 66.0 |
| Total Contract Receivables | \$418.1 | \$419.4 | \$410.2 | \$381.8 |
| Total Contract Receivables Days | 94.3 | 93.5 | 95.3 | 84.2 |

Short-term contract days were flat with the year-ago level while long-term contract receivable days were up by 3.3 days. While the pace of the year-over-year expansion in contract receivable days has slowed, it appears that the company is still utilizing credit expansion to fund sales to franchisees.

On a positive note, the trends in past due contract receivables improved in the quarter:

| Contract Receivables | 3/30/2019 | 12/29/2018 | 9/29/2018 | 6/30/2018 |
|-----------------------------|--------------|--------------|--------------|--------------|
| 30-59 days past due | 0.29% | 0.38% | 0.40% | 0.47% |
| 60-90 days past due | 0.20% | 0.27% | 0.31% | 0.21% |
| >90 days past due | <u>0.32%</u> | <u>1.16%</u> | <u>0.85%</u> | <u>0.82%</u> |
| Total past due | 0.81% | 1.81% | 1.56% | 1.51% |
| >90 Days and Still Accruing | 0.09% | 0.04% | 0.04% | 0.05% |
| | | | | |
| Contract Receivables | 3/31/2018 | 12/30/2017 | 9/30/2017 | 7/01/2017 |
| 30-59 days past due | 0.38% | 0.28% | 0.34% | 0.36% |
| 60-90 days past due | 0.21% | 0.14% | 0.17% | 0.21% |
| >90 days past due | <u>0.57%</u> | <u>0.45%</u> | <u>0.41%</u> | <u>0.44%</u> |
| Total past due | 1.16% | 0.87% | 0.91% | 1.01% |
| >90 Days and Still Accruing | 0.09% | 0.14% | 0.14% | 0.18% |

This paved the way for a \$3.3 million decline in provision expense in contract receivables which would have added about 4.5 cps to EPS in the quarter.

Finance Receivables

SNA's finance receivables include financing to external customers which includes financing to franchisee customers. We will use total non-financial sales in our calculation even though sales to franchisees does not provide an exact timing match to actual sales made to franchisee customers.

| | 3/30/2019 | 12/29/2018 | 9/29/2018 | 6/30/2018 |
|-----------------------------|-----------|------------|-----------|-----------|
| Sales | \$921.7 | \$952.5 | \$898.1 | \$954.6 |
| ST Finance Receivables | \$525.9 | \$518.5 | \$519.0 | \$514.4 |
| ST Finance Receivables Days | 52.1 | 49.7 | 52.7 | 49.2 |
| LT Finance Receivables | \$1,077.1 | \$1,074.4 | \$1,058.3 | \$1,051.3 |
| LT Finance Receivables Days | 106.6 | 102.9 | 107.5 | 100.5 |

| | 3/31/2018 | 12/30/2017 | 9/30/2017 | 7/01/2017 |
|-----------------------------|-----------|------------|-----------|-----------|
| Sales | \$935.5 | \$974.6 | \$903.8 | \$921.4 |
| ST Finance Receivables | \$512.2 | \$505.4 | \$505.8 | \$496.5 |
| ST Finance Receivables Days | 50.0 | 47.3 | 51.1 | 49.2 |
| LT Finance Receivables | \$1,035.9 | \$1,039.2 | \$1,018.6 | \$998.6 |
| LT Finance Receivables Days | 101.0 | 97.3 | 102.8 | 98.9 |

The above table shows that short-term finance receivable days rose by 2.1 days over the year-ago level while long-term finance receivable days jumped by 5.6 days. This is the third straight quarter of substantial increases in long-term finance receivables relative to revenue growth and indicates the company is still utilizing credit extension to drive its sales growth.

The below table shows delinquency trends in the finance receivable portfolio:

| Finance Receivables | 3/30/2019 | 12/29/2018 | 9/29/2018 | 6/30/2018 |
|-----------------------------|-----------|------------|-----------|-----------|
| 30-59 days past due | 0.85% | 1.17% | 1.08% | 1.04% |
| 60-90 days past due | 0.58% | 0.73% | 0.74% | 0.65% |
| >90 days past due | 1.17% | 1.23% | 1.19% | 1.00% |
| Total past due | 2.60% | 3.13% | 3.00% | 2.69% |
| >90 Days and Still Accruing | 0.90% | 0.96% | 0.94% | 0.76% |

| Finance Receivables | 3/31/2018 | 12/30/2017 | 9/30/2017 | 7/01/2017 |
|-----------------------------|-----------|------------|-----------|-----------|
| 30-59 days past due | 0.82% | 1.21% | 1.01% | 0.99% |
| 60-90 days past due | 0.62% | 0.87% | 0.73% | 0.63% |
| >90 days past due | 1.25% | 1.26% | 1.22% | 0.94% |
| Total past due | 2.70% | 3.33% | 2.97% | 2.57% |
| >90 Days and Still Accruing | 0.98% | 0.96% | 0.98% | 0.72% |

Total past due receivables as a percentage of the total portfolio fell by 8 bps with a slight uptick in receivables past due in the 30-59 day range which is not a material concern at this point.

Inventory Continued to Increase

SNA's inventory growth has been outrunning growth in sales for some time. After adjustment for a \$20.9 million increase in inventory from the adoption of ASC 606 at the beginning of 2018, we estimate days sales of inventory in the 12/18 quarter was about 6 days ahead of the year-ago period. Management was asked in the fourth quarter conference call if the company had too much inventory:

“No, no. I wouldn't say we're over-inventoried in big-ticket merchandise. I would say that we're adding a lot of tools. We added 5,000 different line items for Industrial last year. So, we'll keep adding to tools.

Now, you can say okay we are not getting all the sales we want. But if you look at the trajectory of our businesses, if you look at near-term maybe and get in a twist, but if you look at the trajectory of the Tools group over a five, six years, you'll see that it's more than 5%.”

Nevertheless, the increase in inventory continued into the 3/19 quarter with DSIs rising almost 10 days over the 3/18 quarter. We realize that inventory is likely being inflated by rising raw materials prices and higher growth in more expensive diagnostics equipment will also have an effect. However, a 10-day jump on the back of a sustained trend of rising DSIs is concerning.

PepsiCo (PEP) EQ Update -3/19 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 increase our earnings quality rating to a 3+ (Minor Concern) from a 3- (Minor Concern).

Our largest overall concern with PEP was the previous quarter's announcement of the 2019 restructuring plan which will result in \$2.5 billion in new charges through 2023. The company is just now wrapping up its 2014 restructuring plan. We are always skeptical of serial restructurings and their negative impact on the quality of adjusted earnings.

Aside from the restructuring issue, we had only minor concerns with earnings quality in the 3/19 quarter.

- Allowance for doubtful accounts as a percentage of gross receivables recovered slightly in the 3/19 quarter:

| | 3/23/2019 | 12/29/2018 | 9/8/2018 | 6/16/2018 | 3/24/2018 | 12/30/2017 |
|-------------------------|-----------|------------|----------|-----------|-----------|------------|
| Accounts Receivable | \$7,604 | \$7,142 | \$7,975 | \$7,841 | \$7,171 | \$7,024 |
| Allowance for Bad Debts | \$113 | \$101 | \$120 | \$124 | \$141 | \$129 |
| % of Gross Receivables | 1.5% | 1.4% | 1.5% | 1.6% | 1.9% | 1.8% |

Despite the sequential rebound in the allowance, the percentage of gross receivables remains at a low level compared to recent experience. For perspective, it would take about a 2 cps charge to boost the reserve percentage back to year-ago levels. This is not a major concern but could be a mild headwind to future quarterly profit growth if provision expense increases to rebuild the reserve.

- PEP's 10-Q indicates that the company recognized tax benefits of 2 cps related to the TCJ Act. However, the company also noted that it increased the reserves for uncertain tax positions in foreign jurisdictions in addition to other negative timing impacts of the TCJ which would have more than offset the benefit.
- On a non-accounting note, we observe that while the market was excited by PEP's 5% organic revenue growth, this was mostly driven by price increases as volume was only

a positive 1%. Despite increasing investment in marketing and advertising, PBNA (35% of revenue) actually saw 2% volume declines and Quaker Foods (5% of revenue) experienced a 1% erosion in volumes.

Fastenal (FAST) EQ Update -3/19 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 3+ (Minor Concern)

While we have no major concerns with FAST's overall earnings quality, working capital ratios continue to reflect the pressure that the company's growth strategy is putting on cash flow. FAST's CEO summed up the problem well during the quarterly conference call:

"We've talked about this in the past. Our business as it continues to grow with larger customers and with international customers, sometimes we get caught in a situation where you have a customer that's doing some window dressing at the end of a year, end of a quarter, and they frankly stop paying with two, three, four weeks left in the quarter, and it makes for a challenging situation.

Our solution here is to constantly be engaged in discussion with our customer about our value proposition to you is a better supply chain. We take inventory off your balance sheet, don't do this to us at the end of the quarter, because what it ultimately does, it puts us in a position where we can't fund inventory, because there's trade-offs.

If we know if we're going to have an extra \$5 million of receivables, we have to squeeze that somewhere else and that doesn't serve our customer and we need to be engaged in that dialogue and challenge. If you want to do window dressing, do it with somebody else's payable, not with ours. And – but we did produce a stronger cash flow in the quarter and allowed us to pay a higher dividend and reduced that a little bit."

In short, growth is coming from large national accounts, international markets, and the expansion of industrial vending machines and onsite locations. Larger customers and international customers are pressuring the company for better payment terms which is boosting FAST's investment in receivables while the new distribution channels are requiring larger investments in inventory. The erosion in working capital metrics continued

in the 3/19 quarter with accounts receivable DSOs rising 2.3 days to 55.3 and inventory days jumping 2.2 days to 172.5.

Management explained the increase in receivables in the 3/19 10-Q as follows:

“Growth in net accounts receivable in the period was also impacted by the timing of customers’ [payments late in the quarter, a trend that began in the fourth quarter of 2017 and has intensified since that time period. Based on the aging of our receivables, there has been no erosion in the quality of our receivables.”

Management also stated in the conference call with regard to receivables:

“AR grew 15.2% in the first quarter of 2019, with customers continuing to aggressively push payments out past quarter-end. As has been the case in past quarters, we are not seeing any meaningful change in hard-to-collect balances. Reducing these annual growth rates will be an area on which to improve over the balance of the year.”

We will continue to monitor working capital trends going forward.

Gross Margin Continues to Slide

Gross margin fell 100 bps in the 3/19 to 47.7%. This is another side effect of the company’s growth strategy as larger national account customers pressure for better prices and sales continue to shift to lower-margin, non-fastener products. The company also saw pressure from increased shipping costs and lower rebates from efforts to reduce inventory. For now, the move to onsite locations and vending is allowing for operating expense leverage as operating and administrative expense as a percentage of sales fell by 110 bps. We will focus on these trends more in future reviews.

Kimberly-Clark (KMB) EQ Update -3/19 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 raising our earnings quality rating to 3+ (Minor Concern) from a 3- (Minor Concern).

- Inventory days of sales (DSI) jumped by more than 5 days over the year-ago quarter. On the conference call, management attributed this to supply chain restructuring which led to a buildup in inventory to cover for taking equipment offline. We would expect this to moderate over the next few quarters.
- Days payable increased by almost 11 days over the year-ago quarter after an almost 6-day year-over-year increase in the 12/18 quarter. However, payables actually declined sequentially. We remain skeptical that the company has much room to boost cash flow by stretching payables with days to pay suppliers already near 90.

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 recently 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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