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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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AT&T (T) Update of 1Q19 Earnings Maintain BUY

We are maintaining our BUY recommendation on AT&T after 1Q19 earnings which met forecasts. Several positives for longer guidance emerged as well and more reasons to expect the company to beat forecasts. Forecasts only call for annual EPS to grow from $3.52 to $3.58 from 2018 to 2019. The Warner Media deal is 16% of the business has already been accretive since acquired and growing earnings at over 7%. The company is on schedule to realize an annual run-rate of cost savings synergies of $700 million by year-end. That would be 8-cents per share annualized and would be realized in part throughout the year. It is also on track to retire at least $18 billion of debt by year-end – which would also reduce enough interest expense to generate an annual run rate of another 8-cents per share. On top of that, some of the negative issues are showing signs of improving too. This remains a very cheap stock in our view at 8.6x EPS and a 6.6% yield.

- **Debt paydown goals look very likely after recent asset sales.** The company has been preaching rapid debt reduction to about 2.5x EBITDA by year-end. That would mean $18-$20 billion of repayment if EBITDA is flat. Free cash flow of $26 billion looks like a safe bet with $12 billion left after the dividend. For the other $6-$8 billion, AT&T has already completed $3.6 billion in asset sales and pulled $1.3 billion out of working capital.

- **Debt to EBITDA should continue to decline after 2019.** Capital spending is expected to decline later in 2019 and 2020 which helps free cash flow. Getting debt to EBITDA down another 0.25x should only mean about $12 billion debt repayment per year.

- **DirecTV showed some life in 1Q19. Subscriber losses have focused on lower revenue customers, premium customers are staying. ARPU is rising and content costs have declined. EBITDA actually rose $645 million in 1Q19.** About 2/3 of the customers at DirecTV on a 2-year price lock up remain to be dealt with this year, but it appears that the first batch turned out OK, the DirecTV Now service is expected to grow subscribers in 2H19, and with results of 1Q – AT&T is well on its way to achieving its goal of stable EBITDA in this area.

- **FirstNet and 5G rollout are already helping results but are not being priced in.** AT&T is offering faster speeds for free now in 19 cities and should cover 200 million people in the US by the end of the year. This should help customer growth at mobility. They will also start charging for the higher capabilities in 2020 and beyond and could add to ARPU. The also see this replacing some of the business wireline business.

Debt Paydown Looks Very Certain After Recent Asset Sales

AT&T laid out a goal of reaching about 2.5-2.6x EBITDA for debt by the end of 2019. It is using $60 billion in EBITDA as a forecast. That assumes no growth in the year. The company finished 2018 at $171 billion in debt. That should mean paying down debt to $150-$155 billion.

Free cash flow was expected to be $26 billion with $14 billion going to the dividend. The remaining $12 billion would go toward debt retirement. That left another $6-$8 billion to come from asset sales and working capital. Sales of Hulu and Hudson Yards already

produced $3.6 billion in cash early in the 2Q. Reworking collateral for foreign hedges freed up $1 billion in cash in 1Q and another $300 million is expected. Thus, they have already achieved basically $5 billion of that goal. They believe they should reach another $1-$3 billion throughout the rest of the year. AT&T is already at the low-end of the goal and could reach the top-end by year-end. If EBITDA rises at all, that also cuts the debt multiple.

If the company pays down $12 billion in 2020 and 2021, the debt to EBITDA should keep falling to basically 2.25x and 2.0x respectively. Free cash flow would also be helped by falling interest expense, synergies, and declining capital spending levels. The synergies would help EBITDA grow and the declining interest expense and synergies should be earnings tailwinds for growth.

Entertainment Unit – with DirecTV Is Showing Improvement

This is where AT&T has needed to rebuild some credibility with investors after implying that despite raising fees they were not seeing decay in customer numbers as expected. In reality, customer numbers dropped significantly in 4Q18 and EBITDA fell noticeably. The company's forecast changed from stability in summer of 2019 to the end of 2019 for EBITDA.

AT&T TV Unit	1Q19	4Q18	3Q18	2Q18	1Q18
Premium Subs	22,359	22,903	23,294	23,640	23,902
OTT Subs	1,508	1,591	1,858	1,809	1,467
Total Change	-627	-658	-297	80	125
ARPU/Premium	$114.98	$121.76	$114.90	$112.19	$112.45

There are two things happening. In the premium subscribers which is the traditional satellite DirecTV business, has suffered from cord cutting and there was a 2-year price lock on contracts that are rolling off now. Roughly 700,000 rolled off already and another 1.6 million roll off during the rest of 2019. AT&T is keeping some of them at higher price points. Second, the Over The Top (OTT) streaming customers have seen cheap deals expire and AT&T has boosted prices and added premium features like DVR on net.

AT&T has reduced costs on content and other areas. It also has seen broadband bundles help it keep some of the TV viewers. We have pointed out that TV is about 7% of total EBITDA at the company and the full Entertainment Group which includes TV, broadband,

and legacy land-line phones is about 15% of EBITDA (It was 19% for 1Q19). Total EBITDA for this unit improved considerably in 1Q:

Ent. Group	1Q19	4Q18	3Q18	2Q18	1Q18
EBITDA	$2,801	$2,155	$2,434	$2,821	$2,620

The company came into the year forecasting they would stabilize EBITDA here at $10 billion and investors would see that by year-end. A sequential jump of $646 million makes that forecast look more realistic now. The company did not boost guidance and noted that the 1.6 million price lock rolling should be complete by November. It is reporting that the people churning are lower-priced customers where broadband bundles are not available, the highest paying customers are staying. Also, bundles with broadband and mobile help retain premium TV customers. Both broadband and faster mobile are rolling out to more areas.

Also, OTT subs should stop falling in 2Q19 and the new price points are adding more customers for that product too according to the management. The content costs have been adjusted down and higher prices are holding well. Y/Y 2Q added 342,000 subscribers last year which is likely a tough comp. After that, the comps are easy for 3Q and 4Q.

First Net and 5G Could Help Mobility Surprise on the Upside

Mobility at AT&T is still 50% of the EBITDA. It is growing customers at an 8% y/y rate the last two quarters. ARPU is up as well. The only aspect that changes the model is equipment sales – do the people buy the phone from AT&T or show up with one. Equipment sales rise and fall based on phone replacement cycles. Currently, equipment sales are lower and EBITDA rose about 2% for 1Q19.

The basic breakdown here is mobility is 50% of the business and it is growing. The key remaining businesses are each about 15%-17% of the business. WarnerMedia is growing. Entertainment hopes to be flat this year after strong growth in 1Q and become a growth area going forward. Business Wireline is a negative growth story and AT&T manages the decay with cost-cutting. If 85% of the business is flat to growing – this should be a gift at 8.6x EPS.

We also believe mobility could see growth pick-up in 2019 and 2020 with the continued roll-out of FirstNet and 5G. FirstNet has 570,000 customers signed up now. That is with about

half the roll-out complete. The first responders had been an area of low penetration for AT&T and they could become the dominant player there as this network grows. They are also offering family plans to first responders and believe that getting one is often the equivalent of adding two new customers.

As a result of starting up parts of the FirstNet platform, AT&T is now able to offer 5G Evolution in 19 cities. It expects this to reach 200 million people in the US by year-end. The speeds available now on the first cites are 80-150 mb for data and video downloads. They are seeing customer growth from this now. As this network continues to roll out, more people will be seeing this positive change. There are three things to keep in mind:

- AT&T is not charging for this yet. People with a newer phone are getting this for free. They expect to start having plans for this in a few quarters so ARPU could rise in 2020 and 2021 and boost growth at mobility.

- Randall Stephenson noted they are not aggressively pushing this system yet either, "*The value proposition is now one of quality and speed and delivery of video and* ***we're not going out doing a lot of aggressive promotions and we're not doing pricing to try to get customers to stay and come on to the network. It is happening just organically*** *and by virtue of the strategy that we implemented. The 5G evolution of product that we have out there as we turn all this spectrum up and put the new technology on MIMO and so forth, our competitors hate it, but it is having exactly the effect that you wanted to have. Our customers see this tag and they go do a speed check and they're seeing 80, 90, 100, 150 meg speeds depending on where they are. It is truly a step change difference in product capability. And that is having exactly the effect that we had hoped."*

- This could replace some of the business wireline business in factories, hospitals, and other large organizations. Speed and reliability will be there and it will allow for greater automation. This could transform the last lagging business at AT&T into a new growth area for mobility.

We actually do not think any of this is priced in with the stock at 8.6x EPS. If their largest unit starts to see more accelerating growth in customers and pricing for several years – this is potentially a game-changer. Moreover, this would be starting as the Entertainment Group is also showing stability from its TV unit. Just to put some rough numbers on this – here is the change in thinking that could start to happen in the market for AT&T stock during this year.

EBITDA	% EBITDA	Current Growth	Total Gain	Future Growth	Total Gain
Mobility	50.0%	3.0%	1.5%	5.0%	2.5%
Warner	17.0%	7.0%	1.2%	7.0%	1.2%
Entertainment	16.0%	-2.0%	-0.3%	0.0%	0.0%
Wireline	15.0%	-5.0%	-0.8%	-3.0%	-0.5%
Total			1.6%		3.2%

This is back of the envelope thinking just to show that stability in entertainment and higher growth from 5G could essentially double the EBITDA growth rate. This doesn't assume growth from lower interest expense or cost savings synergies also contributing.

Ares Capital Corporation (ARCC) 1Q19 Update Maintain BUY

We maintain a BUY rating on ARCC following 1Q19 results that saw the company beat forecasts by 6-cents. The quarter saw a sizeable increase in new investments and the company has boosted its borrowing lines and is prepared to deal with the June 21, 2019 official change date that will allow the leverage ratio to exceed 1:1 for BDCs.

There are only two issues we saw potentially negative from the announcement: A heavy realization of investments early in the 2Q19 and an increase in Second Lien positions in the portfolio. The rest of the results looked much stronger, and in our view, continue to point to further dividend increases within the next 2-4 quarters:

- **Gross commitments came in just under $2 billion in 1Q19 and net of exits added $600 million to the portfolio. This continued a strong 4Q18 where net commitments were $1.7 billion. In the first 24-days of April, the company was repaid on $747 million against $183 million in new deals. So, the 2Q is starting in the hole.** This is normally a lumpy situation quarter to quarter, and we think it is important to realize that $500 million lower assets at work for a quarter is only worth about 1.8 cents in EPS. ARCC will likely recover part of that in the 2Q and Core EPS of $0.48 exceeds the $0.42 dividend by the widest margin ARCC has had.

- **Second Lien Senior Secured Notes jumped to 39% of new issues from the low 20% range.** Much of this is from one large deal.

- **Portfolio is still showing growth and improvement. EBITDA for investments is rising 5% y/y, non-accruals are down, and debt to EBITDA is essentially flat.** ARCC has much experience with many of these credits and avoids high-risk and cyclical areas like restaurants and construction.

- **There remains considerable room to grow EPS with a number of levers.** The backlog is still $1.1 billion and the net debt to equity ratio is still below 0.8x versus the target of 0.9-1.25x. Higher rates still drive EPS and we believe the company will look more aggressively at repurchasing shares after the leverage limit rules move from 1:1 times debt to equity to 2:1 times in late June.

Jump in Portfolio in 4Q and 1Q Helped Drive EPS

The company completed the remaking of the American Capital Portfolio a couple of quarters ago, which was a big part of above average exits from the portfolio. ARCC moved many of these deals from non-interest earning into income-producing investments. The portfolio size has finally started to increase:

	1Q19	4Q18	3Q18	2Q18
Fair Value Inv.	$13,064	$12,417	$11,220	$11,527
Avg Yield	9.5%	9.3%	9.2%	9.0%
Core EPS	$0.48	$0.45	$0.45	$0.39
Net Debt/Eq	0.79	0.69	0.54	0.57
Fundings	$1,941	$2,275	$1,907	$1,376
Net of Exits	$652	$1,253	-$3	-$754

Rolling the non-income-producing assets over can be seen in the rising yield. The smaller number of exits can be seen in the rising value of the Investment total. This is all positive in our view. With the Net Debt/Equity ratio rising over the next 12-36 months to a range of 0.9-1.25x, that should continue to help.

In the first 24 days of April at the start of 2Q19, ARCC reported that received $797 million in repaid investments or asset sales and only completed $183 million. That's a mild concern to us as it may break some of the momentum. This is always a lumpy part of the business and changes every quarter. The company is still pointing to a $1.1 billion backlog of deals it is looking at.

The company is still committed to expanding the portfolio and has focused on increasing exposure with customers it has a long history with. It called out a $273 million deal in 1Q with IntraPac that has worked with for years. The deal replaced existing banks with a financing package that can scale with the business as an example of this.

In our view, the drop in fundings less exits is mildly troublesome. It may make it difficult for ARCC to finish 2Q with a net positive figure and grow the portfolio this quarter. However, we don't want to lose sight that the portfolio is up over $1.8 billion in the last two quarters. So, a short-term pause at a high level of assets is not necessarily alarming.

Second, assuming a -$500 million swing in the portfolio for the full 2Q19, that is only 1.5-1.8 cents in quarterly EPS. Core EPS is already up 9-cents in the last three quarters and comfortably exceeds the new higher dividend and special dividend of 42-cents.

At this point, it is worth following, but with book value still growing and the asset levels at high levels and the company still focused on boosting leverage ratios, we are not concerned with this potential hiccup in 2Q if it remains a short term issue.

The Surge in New Issue Second Lien Senior Secured Notes Came from One Deal

The company saw new commitments jump in the 1Q19 with more Second Lien Senior Secured Loans than normal:

Commitments	1Q19	4Q18	3Q18	2Q18
1st Lien Sr Sec.	42%	72%	68%	67%
2nd Lien Sr. Sec.	39%	22%	23%	25%

This anomaly came from one large deal – Athenahealth's LBO. This was a $4.9 billion deal with ARCC involved for $1.1 billion of second lien debt. During the period, the company also had a larger exit of Second Lien notes and finished about normal in its total exposure:

	1Q19	4Q18	3Q18	2Q18
2nd Lien Exits	29%	20%	28%	24%
2nd Lien % Portfolio	30%	29%	30%	30%

The company sees better deals when it goes larger as many other BDCs are too small to compete at that level. It also gives it a chance to work with credits it already knows from past deals in many cases. We think the better pricing and spread it can achieve may outweigh some of the negatives of doing larger deals or having a second lien.

The Portfolio Performance Continues to Improve

ARCC highlighted again that it is not trying to match a benchmark for its portfolio. It therefore can avoid areas of lending that can be the most volatile and create the most losses

such as commodities, restaurants, and homebuilding. It can focus on companies with stronger cash flow forecasts and should have a portfolio that suffers less in downturns, rebounds first, and can produce more stable growth. In our February 14, 2019 update we discussed this more as the company recapped the 4Q market place and won't cover this in-depth here.

EBITDA growth continues to be strong for ARCC's portfolio companies, growing at 5% y/y which matched 4Q of 5% also. Debt/EBITDA at the companies in the portfolio is 5.5x now vs. 5.4x in the last three quarters. However, the size of the EBITDA continues to rise indicating ARCC is dealing with more established firms:

Portfolio Cos	1Q19	4Q18	3Q18	2Q18
Wgt Avg EBITDA	$121.8	$99.0	$92.9	$82.4
Avg EBITDA	$66.0	$61.3	$54.1	$49.5

Non-accruals were down to 2.3% of the total portfolio from 2.7% of late. The dollar figure of $314 million was also down slightly. We also saw an uptick in the percentage of the portfolio rated at the company's highest score.

We Still See Several Levers to Pull to Boost EPS

In February 2019, ARCC boosted its outstanding stock repurchase plan from $300 million to $500 million. Only $7 million had been used. We believe the company will use this more after June 2019 when the debt to equity ratio limit is raised to 2:1. Buying back shares would effectively boost the leverage ratio without expanding the portfolio. It should boost EPS and also lower the total dividend outlay. Shares are 426 million now. If the company bought back 26 million shares, at $18 for $468 – first quarter would have looked like this:

	Actual	Proforma
Core EPS	$0.48	$0.51
Dividend	$0.42	$0.42
Total Dividend	$178.9	$168.0
Net Debt/EQ	0.79	0.84

EPS/Dividend would have looked even better and the company would save about $11 million in quarterly dividends going forward. It would raise the Net Debt to Equity ratio slightly which is also part of ARCC's goal. This lever has not been used yet.

Every $1 billion deployed without issuing more equity should boost the debt/equity ratio by 0.14x. That is also 1.5-2.0 cents in EPS per quarter. ARCC is looking to boost the leverage ratio at least over 0.9x would easily accommodate this much more in the portfolio.

We've talked about it in more detail in past updates, but 100bp of higher LIBOR is worth over 4-cents in EPS per quarter. We're not going to predict central bankers' actions and we've never seen government programs end once they begin – like buying mortgage bonds, so interest rates could remain low and lumpy for a time. But we doubt there are many people who believe current interest rates are where we will be forever.

The nature of the business for a BDC is it must pay out the bulk of earnings as dividends, so as EPS grows the dividends should follow as well. This company still looks like the EPS has several areas it can grow 12%-16% very easily from here before factoring in interest rates at all which could be another 8%. Plus, the stock is already growing the dividend which is yielding 9.3% now.

Healthcare Services Group (HCSG) 1Q19 Update Maintain SELL

In the "you just can't make this up" category HCSG continues to tout its strong cash flow, faster collection cycle, and endless growth possibilities. **We are maintaining the SELL recommendation** as we cannot find evidence to support any of those conclusions.

As usual, the company did not file a 10-Q with earnings so we will keep this short until we can see more details. The company remains under SEC investigation for its reporting practices on calculating EPS. That is consuming additional cash and was $6 million in the 1Q19:

- Receivables are UP again!! This is against lower revenue. The company has lost business and is claiming that has now moved 55% of its customers to faster collections cycles as often as weekly.

- Credit quality continues to erode with another $18 million bad debt charge in 1Q19. This is a company that only about 4-5 quarters ago was touting its credit management skills and how all they had to do was convert past due receivable to long-term notes payable and collect the bills and interest. We estimate the bad debt is over 16% of receivables now.

- Endless growth opportunities are being touted again on the conference call. HCSG has not grown its customer base since 2014. It has the bulk of the outsourced market already and operates in nearly every state. Moreover, they are vacuuming and doing laundry – that is not the most difficult skill to replace. If HCSG is not going to extend credit to customers in the form of 60 days to pay the bills – what is their value-add to win new business?

Receivables Are Still Rising and Consuming Cash

In 2018, the company touted it was successfully cutting collection times from customers. Customers were now paying in 7-14 days and that would transform the business into a cash machine and receivables would come down. By the end of 4Q18, HCSG touted that 40% of the customers were paying on much shorter terms. After 1Q19 – that figure is up to 55%.

DSOs for the company were above 70 before they started this program. That figure should be falling rapidly and be well under 30 by now. Instead, receivables are still increasing.

	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17
Revenues	$476.1	$496.4	$506.8	$503.7	$501.8	$499.4
Net Receivables	$392.4	$384.8	$399.4	$381.1	$373.8	$394.2
Net DSOs	75.0	70.5	71.7	68.9	67.8	71.8

This is a screaming red flag because revenues are going down too. In the 4Q18, the company started to lose $20 million in revenues because it was no longer buying the food to prepare at its customer Genesis – that was partially reflected in 4Q18 and fully recognized in 1Q19. It should be seeing receivables decline simply because they aren't billing that $20 million anymore. It lost another housekeeping client in 1Q19 and those revenues aren't being billed either. Yet, receivables are increasing?

This is also a screaming red flag because net receivables are down only because HCSG is writing off a sizeable percentage of them. Another $18 million was moved to bad debt reserves in 1Q19. By our estimate for 1Q19, that makes the bad debt reserves over $75 million now. That figure was $10-$12 million in 2017. Adding those bad debt reserve figures back – DSOs are essentially 90 days now:

	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17
Revenues	$476.1	$496.4	$506.8	$503.7	$501.8	$499.4
Gross Receivables	$467.4	$442.0	$448.0	$430.0	$422.7	$406.2
Net DSOs	89.3	81.0	80.4	77.7	76.7	74.0

Does this look like a company that is speeding up collections? If 55% of $476 million in sales are being collected at even 6x per quarter, that would be $43.6 million in receivables. If the other 45% are still paying at 60 days that would be $142.8 million in receivables. Compare that $186.4 million total to the net receivable number of $392 million or the estimated gross figure of $476 million HCSG is reporting.

Moreover, cash flow is vanishing. Cash from operations in 1Q19 was $18 million but was helped by a $16 million increase in accrued payroll liabilities. Net income plus non-cash charges routinely comes in much higher than cash from operations because working capital is a serious drag at HCSG:

	2018	2017	2016
Net Income	$83.5	$88.2	$77.4
Non-Cash charges	$56.4	$19.8	$16.6
CFO before W/C	$139.9	$108.0	$94.0
Reported CFO	$80.0	$7.6	$41.4

Credit quality is also worth talking about. In the past, a customer who had trouble paying would have the receivable converted to a notes receivable. We viewed this as a way to avoid booking bad debt expense against earnings. But the company believed the notes receivable moved them up in creditor status and could also result in interest income being received. As a result, bad debt potential was reclassified as L-T notes receivable without a bad debt reserve.

The result was bad debt expense and bad debt reserves were typically about $3-$5 million. The DSOs were still generally over 50 days as the free loan enticed customers to sign up in our opinion. Look at the bad debt figures now:

	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17
Gross A/R	$467.4	$442.0	$448.0	$430.0	$422.7	$406.2
Bad Debt	$75.0	$57.2	$78.6	$49.0	$48.9	$12.0
Reserve %	16.0%	12.9%	17.5%	11.4%	11.6%	3.0%

These are even worse as the company has actually written off bad debt reserves and removed them from the account in 2018. Also, it has started to take reserves against the notes receivable too.

Where Is the Growth?

We have been talking about this for some time, but this company is still trading for 27x estimated EPS for 2019 of $1.21. According to Ted Wahl, the CEO – “Beyond some of the recent noise is a consistent maybe even boring business and a compelling growth story that’s simple.”

Our growth question is “where have they been hiding it?” In our reports on this company, we have noted that it has been stuck on 3,500 customer facilities since 2014. HCSG has been around for more than 40 years and operates in nearly every state. Where is the

untapped market for them? The latest call if full of quotes about the great market in front of them, it's never looked better… All HCSG needs to do is finish training their new managers.

The problem is, they have been training new managers for a long time too. We noted how they lost managers going from 8,600 in 2014 to 6,600 in 2018. HCSG has claimed for some time that it is getting new managers ready and spending more to hire them and called out another "one-time" $3 million in 1Q19 for payroll in the "ongoing investment in its training and development ramp-up."

Revenue growth is negative. There is an SEC investigation ongoing. They have not added new customers in years. The company wants to cut back on extending credit to customers in the form of long-term receivables. The bulk of the tasks being done are low-tech areas such as laundry and cleaning – which HCSG hires chronically unemployed people to complete – with a high churn rate of employees and managers. Without free credit – why wouldn't more customers do these mundane tasks in house? The yield is 2.4% and the cash flow routinely is less than income. Why should this be viewed as a growth story at all? If this traded in the mid-teens for a P/E to reflect these issues – it the stock could still get cut in half from here.

McCormick & Co. (MKC) EQ Update- 3/19 Qtr.

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).

MKC's $1.12 in adjusted EPS in the 2/19 quarter topped the consensus by 8 cps. While the company's high leverage and hefty valuation stand out, the quality of the reported earnings in the quarter appeared to improve.

- Days payable rose by 6 days over the year-ago quarter as the company continues to extend payment times on its suppliers. The movement in accounts payable used approximately $36 million in the three months ended 2/19 versus $52 million in the year-ago quarter. With days payable at 80, the company seems to be running out of room to continue to squeeze cash from this source.

- MKC froze its US pension plan at the end of the November quarter, resulting in lower service cost in the 2/19 quarter. We estimate that lower pension expense added about 3.5 cps to EPS growth in the period.

Pension Expense Declined

Since 2016, MKC has frozen the pension plans in both its UK and Canadian operations. As of November 2018, the US pension plan was also frozen and the company no longer accrues benefits for its US employees. This resulted in service costs for the US plan falling from $4.4 million to $0.5 million in the 3/19 quarter. In addition, amortization of net actuarial losses in the US plan fell to $0.6 million from $2.5 million last year. These two factors resulted in $1.3 million in pension *income* in the 3/19 quarter compared to $4.0 million in pension *expense* in the year-ago period.

Pension Expense (Income)	2/28/2019	11/30/2018	8/31/2018	5/31/2018
US Plans	-$0.8	$3.2	$4.0	$3.9
International Plans	-$0.5	$0.0	-$0.1	-$0.1
Total Pension Expense	-$1.3	$3.2	$3.9	$3.8

Pension Expense (Income)	2/28/2018	11/30/2017	8/31/2017	5/31/2017
US Plans	$4.0	$3.0	$2.2	$2.1
International Plans	$0.5	-$3.9	$1.2	$1.2
Total Pension Expense	$4.5	-$0.9	$3.4	$3.3

We estimate that this benefit added almost 3.5 cps to the EPS growth rate in the quarter. The year-over-year benefit to growth will last for another three quarters.

Stryker (SYK) EQ Update- 3/19 Qtr.

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).

SYK reported adjusted EPS of $1.88 in the 3/19 quarter which beat the consensus estimates by 4 cps. While the company's tax rate of 14.4% appears to been slightly below what may have been forecast due to the timing of stock option recognition, management noted that FX reduced EPS by about 2 cps more than expected at the beginning of the quarter so we consider that a wash.

We have the following observations regarding earnings quality trends in the quarter:

- The increase in inventories has begun to level out with DSIs rising only 6.6 days which was also likely elevated some by the acquisition of OrthoSpace in the last month of the quarter.

- Contract liabilities (deferred revenue) rose slightly on a sequentially marking the second straight sequential rise. We had expressed mild concern over the sequential decrease in the 9/18 quarter. We will continue to monitor this trend but our concerns are reduced at this point.

- Prepaid expenses and other assets have been gradually increasing for the last few quarters on a days-of-sales basis and as a percentage of total assets. There is no discussion of the cause in recent filings. While multiple factors could be at play, the possibility exists that income statement recognition of cash amounts spent have been delayed which could be artificially benefitted results. However, given the lack of visibility into the issue, we are not ready to attach a high degree of concern to this trend.

While we are identifying a new concern with prepaid assets, the improvement in inventory trends and contract liabilities prompt the increase in the earnings quality rating.

Prepaid Assets Increasing

For several quarters, SYK's prepaid and other assets account has been gradually rising on both an absolute basis, a days-of-sales basis, and as a percentage of total assets as seen in the following table:

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Prepaid Expenses and Other Current Assets	$782	$747	$739	$664
Sales	$3,516	$3,796	$3,242	$3,322
Total Assets	$25,937	$27,229	$22,084	$21,570
Days of Sales	20.3	18.0	20.8	18.2
% of Total Assets	3.0%	2.7%	3.3%	3.1%

	3/31/2018	12/31/2017	9/30/2017	6/30/2017
Prepaid Expenses and Other Current Assets	$624	$537	$602	$547
Sales	$3,241	$3,471	$3,006	$3,012
Total Assets	$22,133	$22,197	$21,485	$21,292
Days of Sales	17.6	14.1	18.3	16.6
% of Total Assets	2.8%	2.4%	2.8%	2.6%

The company does not offer an explanation for the increase in its prepaid and other assets account in recent filings so we cannot pinpoint the cause. Other assets could contain such items as unbilled receivables. However, the company specifically states in its revenue recognition disclosures that it does not have contract assets. Generally, a prepaid asset is booked when the company has made a cash payment but has yet to recognize the expense on the income statement. Therefore, a rise in prepaids could indicate that a company has become more aggressive in reporting by delaying the recognition of expenses. The consistent, gradual increase does draw attention to the trend. However, given the lack of insight into the cause, we are not ready to attach a high degree of concern to the increase.

Lancaster Colony (LANC) EQ Update- 3/19 Qtr.

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).

LANC missed earnings targets by 10 cps in the 3/19 quarter. Most of the shortfall seemed to be higher than anticipated costs related to recent acquisitions and the resumption of brand marketing investment in its New York Brand Bakery. Analysis of the likelihood of recent acquisitions living up to expectations is beyond this earnings quality review. From a purely accounting level standpoint, we actually saw some improvement in the quarter:

- Inventory days of sales were essentially flat with the year-ago quarter with the finished goods percentage also stabilizing. This reduces our mild level of concern with recent increases in inventory balances.

- The company expensed an $88,000 increase in the value of contingent consideration related to acquisitions in the 3/19 quarter versus a $525,000 increase in the year-ago quarter. Remember that this compares to a more than $9 million *decrease* to the value of contingent consideration recorded in the 12/18 quarter. Given the timing of the write-down of the contingent consideration in the 12/18 quarter following by significantly higher costs related to acquisitions in the following quarter, we can't help but wonder if the two were somehow. related. For now, it appears that the outlook for its acquired operations has stabilized.

Colgate-Palmolive (CL) EQ Update- 3/19 Qtr.

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).

CL has experienced a small rally after topping EPS targets by a penny in the 3/19 quarter. We continue to doubt the company can experience much in the way of growth with organic volume growth of 3% in the quarter coming from a 2% increase in prices and only a 1% increase in volume.

- Meanwhile, adjusted gross margin fell by 110 bps from higher raw material, packaging, and FX more than offsetting the beneficial impact of cost savings and price increases.

- At the operating line, adjusted operating margin fell by 180 bps as a 60 bps increase in advertising expense added to the gross margin erosion.

- The company continues to expect its current restructuring program to be complete by the end of 2019. However, given the poor growth and cost pressures, we will be surprised if another round of restructuring spending is not announced before then.

- Cash flow remains an issue as operating cash flow continues to decline and lower capex is the only factor allowing the company to maintain positive free cash flow growth. Free cash flow after dividend and buyback is a negative $235 million with the reduced share count adding a much-needed 1.5% tailwind to EPS growth.

- Despite the fundamental negatives that remain, we are raising our earnings quality rating as the growth in days sales of inventory has flattened out.

And Now for Something Completely Different…

Saturday is the Kentucky Derby and we always look at horse racing as being financial analysis where you get the answer in 20 minutes. Looking for some strong odds possibilities and the potential for rain and an off track. Maximum Security #7 is 10 to 1 odds. He is the only horse in the field with a speed figure over 100 and he has done it twice. He does not have problems getting out of the gate and may only have to beat the 4 and 6 out of the gate to get great position early and avoid getting banged around as happens with a 20 horse field. Maximum Security will get more pressure than he did in the Florida Derby but he looks much better than the other early speed. We will also highlight two late runners for second place. Win Win Win, the #14 horse, is 15 to 1 odds. It is virtually impossible to run down front horses at Keeneland and despite a horrible start there, he rallied from 13th place to finish 2nd. Tacitus, the #8, is 10 to 1 odds and probably won't be coming from as far back as the #14. Tacitus has ground out tougher wins than both #7 and #14 and his rally beat Win Win Win's late rally already. All three have shown they can run on mud too. Good Luck!

Explanation of EQ Rating Scale

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